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Canada. Royal commission on banking and finance.

Report. 1964.


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REPORT OF THE ROYAL COMMISSION ON BANKING AND FINANCE



CANADA

1964 - - Report of the Royal Commission on BANKING AND FINANCE

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Price subject to change without notice

ROGER DUHAMEL, F.R.S.C.
Queen's Printer and Controller of Stationery
Ottawa, Canada
1965

Reprinted 1966

TO HIS EXCELLENCY

THE GOVERNOR GENERAL IN COUNCIL

MAY IT PLEASE YOUR EXCELLENCY,

We, the Commissioners appointed by Order-in-Council dated 18th October, 1961, P.C. 1961-1484, to inquire into and report upon the structure and methods of operation of the Canadian financial system, including the banking and monetary system and the institutions and processes involved in the flow of funds through the capital market; and to make recommendations concerning the matters more specifically set forth in the Order-in-Council dated 18th October, 1961:

BEG TO SUBMIT TO YOUR EXCELLENCY
OUR REPORT

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CHAPTER 1

A GENERATION IN PERSPECTIVE

When our predecessors on the Macmillan Commission laid down their pens thirty years ago, they looked out on a world very different from that confronting us who now, a generation later, must pick up ours. In 1933 the great depression was at its lowest point, prices had fallen drastically, international economic co-operation had broken down, the world financial system was crumbling, and Canadians staggered under a burden of debt which, in relation to their incomes, was the heaviest in recorded history. Although our financial system had not experienced the wave of failures that plagued the United States, a substantial contraction in bank and other credit had nevertheless intensified our difficulties. People of every shade of opinion were offering solutions to the world's problems, but perhaps the most discouraging feature of the times was that no one really had any firm idea as to how or when hardship could be ended and prosperity restored. Adversity is supposed to be not without its comforts and its hopes, but optimists were few in number and not considered very credit-worthy; caution, not enterprise, was the virtue of the day.

We face a changed, but no less challenging, environment. Our economy is much more urban, industrialized, and diversified, and enormously richer—the volume of national production is now some five times that of thirty years ago. Price trends, too, give us a different perspective; the price increases which have been such a pervasive feature of the post-war world would not have been such a problem to Lord Macmillan and his colleagues. Moreover, we have lived in an age of strong demand for capital to take advantage of the new market opportunities and the more efficient production methods developed by modern science and technical know-how. This increased investment demand has come from business, consumers and all levels of government, and raised total annual investment in Canada, including investment in consumer durable goods, to over $12 billion in 1963, from under $¾ billion in 1933. These vastly greater flows of investment have given us a much larger and more up-to-date stock of real wealth—business capital in the form of plant and equipment, social capital like roads, schools, and hospitals, and consumer capital such as houses, cars, stoves, and washing machines. Yet the world-wide hunger for capital is still intense; the increasing needs of modern economies for large amounts of domestic investment, the awakening appetites of the undeveloped countries, and the insistent demands of the Cold War have combined to out-run our ability to satisfy them. Although we live in a world different and more dangerous, changing and more competitive than that inhabited by our predecessors, we live in one more aware of the interdependence among nations; the limits imposed by the international climate on any one country's ability to pursue completely independent policies are now more widely recognized—not only in Canada with its close ties to the United States—but elsewhere as well. Many of the hopes expressed by the Macmillan Commission for improved international economic and financial co-operation have been realized, but our long-run growth is still as dependent on such con-

structive co-operation today as it was thirty years ago.

These developments in the physical or "real" world have been matched by no less striking changes in our financial system, in the size and scope of the tasks it is called upon to do, and in the nature of the problems we are called upon to solve. The greater size of the real economy is reflected in the size of the assets of the main financial institutions which now are over $42 billion compared to $5½ billion in 1933. Bigness in government, in corporate life, and in trade unionism has been matched by bigness in the financial institutions—the balance sheet of our largest bank exceeds $5 billion, seven times that of thirty years ago, and parallel developments have occurred in other institutions. Like physical production, financial activity of some types has also become more concentrated—there are now only eight banks against ten thirty years ago, and the largest three continue to hold 70% of the assets; however, as in the real economy, increased concentration is not the universal pattern in the financial system—for example, the sales finance and life insurance industries are both less concentrated than in earlier years. The increased complexity and larger scale of economic activity have also resulted in fewer of the country's credit flows being arranged directly between borrowers and lenders and more being handled through the intermediary financial institutions which can spread the risks and bring to bear the necessary financial skills; more of the primary debt outstanding is now held by the institutions than in the early thirties, with most of this increase taking place in the early post-war years.

The wider variety of Canadian economic activity has greatly increased the need for diversified financial services and many new or virtually new institutions have sprung up to provide them. Perhaps the most familiar and striking examples are the credit unions, which were virtually unknown three decades ago, and the caisses populaires, which had assets of under $10 million; the combined size of this co-operative banking movement of smaller savers and borrowers is now over $1½ billion. Development companies have been established to provide medium and long-term capital for small or relatively new businesses; mutual funds have proliferated and the investor can now conveniently purchase a diversified and professionally managed portfolio of common stocks; and new types of real estate, mortgage, and leasing companies have been established. The instalment finance companies have also undergone very vigorous growth, reflecting the strong demand for consumer durable goods—their assets were under $75 million thirty years ago compared to some $2 billion today.

The older established institutions, too, have undertaken new activities and approached their traditional lending fields in a more vigorous and imaginative way—old-time bankers would surely shudder at the very thought of instalment loans and N.H.A. mortgages in bank portfolios. The Quebec Savings Banks have become actively involved in mortgage lending in the urban areas where they operate, while the trust and loan companies have intensified their traditional efforts to collect deposits and become more venturesome in the mortgage and investment field, with the former being particularly active in the relatively new pension fund business. The insurance companies have offered a variety of new types of insurance plans, and have moved into the field of variable annuities. Industrial companies and other non-financial participants in the system have stepped up their financial activities and more business is being financed on trade credit. The role of non-residents in our financial system has also changed dramatically; foreign investors held some 40% of all Canadian bonds outstanding in the mid-thirties, against about 15% today, but are now playing a much more active role in equity ownership. It is a rare class of financial institution indeed that has faded entirely from the scene, although the penny banks—presumably victims of inflation—have done so, and a few others, like the federal Post Office Savings Bank, are now smaller in size than they were thirty years ago.

The emergence of new types of institution and of new methods of financing has had its counterpart in the wide variety of new financial instru-

ments offered to the Canadian saver. While chartered bank notes have been replaced by Bank of Canada notes as the principal currency, the citizen now has a great array of current account, time and savings deposits, longer-term debt instruments, and equity securities from which to choose. We have been especially struck by the increase in the number of issuers of highly liquid short-term claims which, if not money, are at least very good substitutes for money. We include not only the deposits of some of the institutions mentioned above, but the appearance of government savings bonds, redeemable at par, and of short-term market instruments such as commercial paper and day loans to investment dealers. These developments have been made possible by, and contributed to, the rise of new markets like the money market in whose establishment the Bank of Canada played a central role. The stock and bond markets are also better able than formerly to handle larger transactions smoothly and efficiently, while strengthened regulation of these markets by both government and the participants themselves has eliminated a number of their past abuses and flaws. Regularly amortized mortgages have become the rule rather than the exception and have removed many of the dangers inherent in the old system under which little or no principal repayment was made during the life of the loan; even in this specialized field we have witnessed the beginning of a trading market. Such changes in the financial system have proceeded at an unabated pace even during the life of this Commission. Increased competition and venturesomeness in the financial system have been reflected in the establishment of new companies to supply equity funds to promising young businesses, to invest in N.H.A. mortgages, to insure conventional mortgages, to make term loans to business, and to provide a number of other new financial services.

This more varied, flexible, and competitive financial system has resulted in some of the older and less aggressive institutions losing ground, although they are still dominant in their field. The banks, for example, account for about two-thirds of the assets of institutions doing a short and medium-term credit business compared to over 80% in the time of the Macmillan Commission; the life insurance companies, which then had almost all the assets of institutions investing at longer term, now account for somewhat over half the total. These tangible changes have been accompanied by no less important but intangible changes in the conventions, habits, and attitudes of many credit-grantors. Salesmanship and a desire to help the borrower or lender meet his needs are no longer considered as something suitable for commerce but below the dignity of finance—to a surprising degree aloofness has given way to amiability and aggressiveness in the financial sector.

Obviously these changes and improvements in the system have for the most part been welcome, but they have raised a number of new problems. Indeed, it would be surprising if a framework basically designed many years ago, although considerably modified since, were appropriate in all respects to the changed conditions of today. The financial system has a bigger job to do, regulation and supervision requirements have changed —and not just for the new institutions which have sprung up outside the present framework— and the terms of competition between institutions are in need of review.

A vital role is played in any modern financial system by government financial policies and policy-making institutions and by the public attitudes which condition them. Nowhere more than in this part of the system have there been such striking changes since the last banking commission reported. Growing government participation in economic life has been reflected in increased government lending and related financial activities; Central Mortgage and Housing Corporation, the Industrial Development Bank, provincial development funds, and the Export Credits Insurance Corporation have been set up by governments and a number of guaranteed lending programs instituted. The authorities are also more closely linked to international finance through participation in the International Monetary Fund, the International Bank for Reconstruction and

Development, and the Organization for Economic Co-operation and Development.

Most important, government has become much more interested in financial policy and much more oriented to the pursuit of the major economic goals of full employment, price stability, efficiency, and the maintenance of a sound external position. To help achieve these objectives, the Bank of Canada was incorporated in 1934 as the Macmillan Commission had recommended and monetary policy has come to play an active and increasing role in our economic life. Fiscal measures too have been used more extensively, although not always adequately, to achieve national objectives, while debt management, foreign exchange and international economic policies are being used in ways that were undreamed of thirty years ago. Growing experience has led to the development of a whole new range of policy instruments and techniques and to greater public acceptance of their use. There has been some increase in public awareness of the implications of financial policy, although it has not kept pace with the demand for ever-higher standards of performance in attaining policy goals.

If times and the role of financial policies have changed, so have our problems. In the immediate post-war period the problem was one of controlling inflation—international competition was nonexistent, there was a huge backlog of domestic demand, and the public held a large stock of highly liquid assets in the form of money and government bonds which was used to finance high levels of spending. After a variety of experience in the interval, including two mild recessions and a huge investment boom, the basic economic climate changed in 1957; the country entered a period of slower growth and higher levels of unemployment; however, widespread fears of inflation persisted as did a deficit on our international current account which gave rise to concern that Canadians were not financing enough of their own development. Competition from the rebuilt and modernized economies of other countries became more vigorous and led to increasing worry in some quarters that policies designed to stimulate the domestic economy would result in higher wage and other costs and an undermining of our competitive position rather than in higher employment.

International payments arrangements became of increasing concern, and many of those who only a few years before had been worrying about a dollar shortage began to be concerned about the opposite problem of deficits in the United States balance of payments position. In Canada, this took on a special significance after the exchange crisis of 1962, which had been preceded by a number of direct measures to influence the balance of payments and by abandonment of the floating exchange rate system in use for more than a decade. It also led to the restoration of a fixed bank rate, which had not been used since 1956. The episode indeed serves to illustrate that the process of change in recent years has affected financial policy no less than the private institutions and markets. In this changed environment some of the earlier, easier hopes that financial policies, and especially monetary policy, could play a powerful part in solving national and international problems were called into question. A minority of informed opinion has even gone so far in recent years as to allege that monetary policy in particular was more likely on balance to do harm than good. Clearly, these developments require us to examine Canada's financial machinery and policies in a perspective different from that of our predecessors, to weigh carefully the evidence gained from a generation of experience, and to focus closely on the new and exacting conditions in which the system must operate.

These many changes in our financial system and in the needs it must meet could be shown by a series of statistical tables giving the size and composition of the flows of financing in the Canadian economy in different years. Unfortunately, financial statistics in Canada are not sufficiently developed for us to do this, and we can only present a partial picture here and elsewhere in our report. Ideally, we would like to know the gross source and application of funds of each economic unit, defining an economic unit as an individual household, business, or government. The principal source of funds for most such units

is income from the production of goods and services, and the main application is ordinary current account expenditures on goods and services. Those units which still have surpluses can then apply them—if they choose to do so—to finance their own investment expenditures on either newly produced goods—including consumer durables—or on existing physical assets such as a used car or machine. The remaining surplus units will have a balance of funds to apply either to the purchase of financial assets like bonds and bank deposits or to the repayment of existing obligations such as bank loans or mortgages. Command over goods and services is thereby transferred by the surplus units to other units which have spent more than their current incomes, either on consumption alone or on consumption and investment in real goods and services combined (after any disposal of existing physical assets). The application of funds to financial investment by the surplus units is the source of financing for the deficit units, which will find that their financial positions have been impaired, either by running down their holdings of financial assets—including money—or by increasing their debt or other obligations. Other circumstances in which flows of funds arise are when a unit wishes to apply extra funds to the purchase of financial assets such as mortgages and has to borrow to do so, or when, say, a household wishes merely to alter the composition of its existing financial assets or liabilities; both these last transactions have the effect of supplying funds to some parts of the economy while demanding an equal amount from others.

Obviously not all these possible sources and uses of funds touch the financial system. Quite apart from the consumption and investment expenditures financed within a single unit out of current financial savings—as when a corporation finances some or all of its investment out of retained current earnings or an individual buys a washing machine from his pay-cheque—there are other capital and credit transactions which do not involve the financial institutions or markets, being arranged directly between non-financial participants whose main business is dealing in goods and services, e.g. a manufacturer (resident or non-resident) who extends trade credit to a customer, or an individual who buys a house directly from the seller. We are particularly interested in the other two categories of transactions; those which are done between a primary borrower and ultimate lender but through the agency of the financial markets and those which involve the financial institutions themselves, as when a bank or instalment finance company extends credit to a business by making a loan, a life or trust company alters its investment portfolio by selling a government bond and buying common stock, or a credit union expands its liabilities to the public by increasing its outstanding shares. Although we do not have the data to show either the precise role of every financial institution in total gross financing activity in Canada or all the changes in the various channels through which financing has flowed, we do have enough information to show the main trends.

Much the same is true of balance sheet data. We could provide an accurate picture of the wealth of Canadians at different periods if we were able to construct tables showing the assets and liabilities of Canadian governments and resident businesses and individuals. The asset side would of course show in detail the various forms of physical assets and financial claims in which wealth can be held, with a deduction for the proportion of these held by non-residents; the liabilities side would show outstanding debt and a balancing item indicating the net wealth of the Canadian economy; the latter item would reflect the fact that debt held as an asset by some units within the economy is the liability of other units and cancels out for the economy as a whole. However, we have no information on our stock of physical wealth, although we know from the studies of others that it is very much greater than the total of debt outstanding. Nevertheless we have been able to compile the following table, showing the principal forms of primary debt outstanding in various years; this comprises the vast bulk of the total, including trade credit extended to businesses and individuals, but excludes both non-mortgage debt owed by one individual to another and outstanding equity shares.

TABLE 1–1

PRINCIPAL FORMS OF PRIMARY DEBT OUTSTANDING[a]
(December 31)

	1935		1940		1945		1950		1955		1962	
	$ Billions	%	$ Billions	%	$ Billions	%	$ Billions	%	$ Billions	%	$ Billions	%
Government of Canada[b]	4.1	33.7	5.2	38.3	17.5	67.3	15.9	50.1	16.0	36.3	19.4	27.0
Provincial Governments[b]	1.7	13.8	2.0	14.8	1.9	7.4	2.8	8.9	4.2	9.4	9.0	12.5
Municipal Governments[b]	1.4	11.2	1.2	9.1	1.0	3.7	1.3	4.1	2.3	5.3	4.3	6.0
Business	2.8	23.1	2.9	21.3	2.7	10.3	4.7	15.0	8.3	18.7	14.5	20.2
Trade Credit[c]	n.a.	n.a.	n.a.	n.a.	1.0	3.8	2.2	7.1	4.0	9.2	5.4	7.4
Mortgages[d]	1.7	13.9	1.6	11.6	1.3	5.1	3.1	9.8	6.2	14.2	14.0	19.5
Other Personal Debt	0.5	4.3	0.7	4.8	0.6	2.2	1.6	5.1	3.0	6.9	5.3	7.3
TOTAL	12.2	100.0	13.7	100.0	26.0	100.0	31.7	100.0	44.1	100.0	72.0	100.0
Total as % of G.N.P.	282%		203%		219%		176%		162%		178%	

[a]Interpersonal debt and equities are not included. Data have been partially estimated.
[b]Includes debt held in accounts of the respective governments.
[c]Partial data based on taxation statistics for fully tabulated companies other than retail trade and financial companies, for which better information is available from other sources. The trade credit figure shown for 1962 relates to 1960, the latest year available.
[d]Residential and non-residential mortgage debt outstanding, including an estimate of mortgages held by individuals.

This table clearly illustrates some of the main trends noted earlier, such as the great growth in debt outstanding and the changes in its composition. The last line of the table relates this debt to the dollar value of national production and shows that this ratio, at 178%, is far below that of the mid-thirties—the figure was well over 300% in 1933—or even at the end of the war. However, it is about the same as in the late twenties and in 1950 when the principal post-war adjustments were completed. The latter comparison conceals some running down by the economy of its liquid assets in relation to income and is also affected by the intervening price increases, but the picture presented nevertheless is broadly accurate and does not confirm the allegations of some that our post-war prosperity has been purchased only at the cost of acquiring a disproportionate burden of debt in relation to income. In many individual instances, of course, less favourable economic conditions and rising debt levels have increased the riskiness of granting credit; on the other hand, new lending techniques have reduced the risk of lending and enabled institutions to meet the legitimate needs of those who hitherto had had to rely on unduly high-cost sources, if they could obtain credit at all.

The composition of debt has of course also changed significantly over the years. The figures for the federal government reflect the huge deficits incurred to finance the war, the subsequent post-war surpluses, and the recent re-emergence of deficits; it is interesting that these latter deficits, despite their much larger absolute size, are only about one-third as big in relation to national production as those in the early 1930's. Provincial government debt outstanding, after falling in the war years, has grown sharply in the post-war period, reflecting the outlays of such provincial enterprises as power commissions and—in recent years—the emergence of overall deficits in provincial budgets. The table also clearly reflects the fact

that municipal governments have been running increasingly large deficits since the war, partly because of their need to provide much of the social capital facilities demanded by our urban society. The growth of business debt outstanding in the post-war period is a natural accompaniment to the large investment outlays by this sector, particularly in the middle and late 1950's, and has occurred despite a large amount of internal finance; the growing use of trade credit, largely within the business sector, is also shown. The most dramatic change has however been in consumer debt and mortgages outstanding, reflecting the spread of home ownership and the increased use of consumer durables. In addition to financing this growth in household investment, persons as a group have in most post-war years been net suppliers of funds to governments and other sectors of the economy, although since 1950 the total demand for financing could not be met from domestic sources and increasing use has been made of non-resident funds. From 1933 until 1949 Canada in fact supplied funds to the rest of the world, but in every year but one since then we have drawn on foreign savings, in 1963 to the extent of about $500 million.

OUR APPROACH TO THE TASK

The preamble to our terms of reference explicitly draws attention to the changes in Canada's economy and in its financial resources and requirements since 1933, a reminder that our review of the Canadian financial system can be useful only if it is illuminated by an understanding of the broader economic environment in which the system must operate. We have tried, therefore, to animate our enquiry with a lively appreciation of the wider problems which confront the economy so that we may assess more accurately the role that financial policies can, and should, be expected to play in meeting the nation's major objectives. A well-functioning financial system and appropriate financial policies imaginatively executed can clearly help to overcome some of the obstacles faced by Canada, but they are no panacea, particularly in our open economy which is so subject to influence from international events beyond the power of Canadians to control. At home, too, our progress depends on far more than the possession of a fully-developed financial framework; vitally important are our attitudes towards work, risk-taking and saving; the enterprise, skill, and self-discipline of our people; our real resources and our progress in research; our willingness to meet the challenge of changed conditions in a constructive way; and the appropriateness of our institutions and government policies of a non-financial nature. One of the key questions to which we have addressed ourselves, therefore, is that of trying to assess the contribution which financial policies might reasonably be expected to make in achieving our country's main economic goals.

A second and closely related question that has been constantly before us is the extent to which the effectiveness of financial policy might be strengthened by changes in existing techniques, by improvements in its timing and in the underlying statistical and other information on which it is based, by the introduction of new policy measures, and—most important—by better co-ordination of each of the strands of financial policy, particularly monetary policy, with the others and indeed with non-financial measures. This has necessarily involved us in a close examination of the record of recent policy measures; however, we have not carried out this examination with the idea of passing out praise or allocating blame. We believe that it is more constructive to examine the past primarily for the purpose of trying to determine what we might realistically and reasonably expect to achieve in the future. We recognize that financial policy has not played its full part at all times, and indeed that it is never likely to do so in a world of imperfect foresight, but we feel strongly nevertheless that all possible avenues of improvement should be studied and that the failures of the past do not inevitably mean that we should aim our sights at a lower target in the future.

A third major question which occupied much of our attention was the considerably different one of the safeguards afforded to the public in

its dealings with the financial sector. A properly-functioning financial system must have the confidence of both lenders and borrowers to encourage an appropriate amount of saving and risk-taking, and the framework of supervision and regulation protecting the public against fraud, misleading or incomplete information, negligence, and exploitation obviously plays an important role in creating and maintaining such confidence. In our approach to this part of our task, we have tried to make recommendations which meet the need without at the same time bequeathing a legacy of unnecessary rigidities and obsolete rules which leave the financial system no discretion at all to develop those traits of vigorous innovation and creative competition we deem essential to its success.

This leads us to the fourth and last major issue on which our enquiries were centred, the extremely important question of the adequacy of our financial system to meet the legitimate present and prospective needs of lenders and borrowers in an efficient, flexible, non-discriminatory and creative way. An efficient financial system not only must encourage the transfer of funds from surplus to deficit units but must provide many other facilities essential to the progress of modern society, including a convenient and economical means of making payment for every kind of transaction and the provision of safe-keeping, life insurance, and trustee services. If the financial system fails to fulfil all these functions, or performs them only imperfectly, the result will be to deter some economic activity from taking place. At the extreme one can imagine a situation in which every economic unit had to preserve an exact balance between its revenue and its expenditure or else resort to barter—no large-scale specialization or diversification could take place under such an inefficient system. In a similar but much less extreme way, a financial mechanism which does not provide the wide variety of instruments, pools of special skills, and highly developed borrowing facilities needed in our complex economy, which fails to meet the needs of lenders for a broad range of outlets for their funds, or which does these things only at an excessive cost, will inevitably cause employment, production and growth to fall below their potential. Saving will be discouraged by the greater risks, inconvenience, and cost involved, while physical investment—which accounts for more than a quarter of national production and constitutes the largest source of demand for funds—would be curtailed both by outright inability to finance and by the excessive charges and inappropriate conditions demanded by lenders.

A financial system which is not flexible will have the same effect; if the system is badly compartmentalized and pressures in one sector fail to be reflected in another, some borrowers will find their spending plans frustrated while some lenders will find no suitable outlet for their funds. This is true also if a system discriminates against certain classes of borrower and saver or against any region or locality within the country by failing to provide financial services at all or by providing them only under terms which are out of line with the underlying risks and costs. A similar distorting and depressing effect on economic activity will take place if financial markets are not broad, self-reliant, well-informed, adaptable and sensitive to changing yields and other factors which reflect the constantly altering preferences of the community. Financial institutions and markets are also the vehicle for transmitting the main impact of financial policy, and if they do not adequately reflect the changed attractiveness of spending on real goods and services relative to the acquisition of financial assets, the financial system will frustrate the authorities' principal aim of altering the level of physical activity in the economy.

A creative financial system is one which does not just passively accommodate the usual—instead, it is one in which active and inventive efforts are constantly being made to meet the sound requirements of lenders and borrowers, regardless of how untried and unusual such needs may be. A spirit of vigorous, restless innovation in the financial system—of devising new ways to do new things rather than of justifying why they should never be done at all—can ordinarily best be achieved in conditions under which the partici-

pants are not prevented from responding to changed opportunities, in which price and other competition is too intensive to be comfortable, in which there is relative ease of entry for honest men with ideas and imagination, and in which different classes of institution can compete with each other on an equitable and open basis.

These major considerations, and many other issues as well, have been prominently in our minds as we have carried out the terms of reference which command us:

> "(*a*) To inquire into and report upon the structure and methods of operation of the Canadian financial system, including the banking and monetary system and the institutions and processes involved in the flow of funds through the capital market; and
>
> (*b*) To make recommendations
>
> (i) for the improvement of the structure and operations of the financial system and, more particularly,
>
> (ii) concerning the Bank Act, the Bank of Canada Act, the Quebec Savings Banks Act, and other relevant federal legislation."

While the Macmillan Commission was able to confine its inquiry entirely to banking and currency, we have felt it necessary to take a broad view of our already broad instructions. We have naturally devoted our main attention on the policy side to the monetary system and to the role and responsibilities of the Bank of Canada but as we have already indicated, the issues which they raise can only be viewed sensibly in a broader context. Monetary policy operates as part of a "mix" of policies and its potential must be examined in relation to the potential of these other policies—fiscal, foreign exchange, and others. Hence we felt we should study at least some of the more relevant questions which are suggested by use of the latter policies, although we have been happy to leave a close examination of fiscal policy in the highly competent hands of the Royal Commission on Taxation. Similarly on the institutional side we have intensively examined the non-bank financial institutions, not only because they have become an increasingly important part of the financial system in their own right but because it is only from this wider perspective that a proper view can be obtained of the chartered banks and the laws which regulate them. Obviously, however, we could not hope to deal with every aspect of the operations of the financial system which is affected by the decisions of others in the economy. Alterations inevitably occur in the flow of funds through the capital markets when the price of any commodity changes but we have confined our studies of the non-financial participants in the system to their main sources and uses of finance and to the financial implications of the principal production and price trends which they have experienced.

An inquiry such as ours has naturally been highly dependent upon the help of others. We have elsewhere acknowledged our gratitude to the distinguished individual witnesses from Canada and abroad who extended such valuable assistance to us. We have also recorded there our appreciation to the major associations of financial institutions and primary borrowers and lenders and to many of their individual members, all of whom provided us with much useful information and answered the numerous questions put to them by us and our staff with unfailing courtesy and helpfulness. In addition to the many studies prepared by our research staff, we were greatly aided in our work by the 110 briefs we received and by the testimony given by the many witnesses during 69 days of public hearings held in 11 centres across Canada. In all, we made heavy demands on Canada's public and private financial institutions; we can only hope that they found the process of helping to inform us valuable in learning a little more about themselves.

With their assistance we were able to develop a number of new statistical series and related information about the financial system, most of which will be found or reflected in this report, its appendix volume, or in the studies already referred to. In general, however, we did not try to pioneer the development of highly complex statistics not likely to be available on a continuing basis, although some special data—for example on the investment activity of life insurance companies and on the estates, trust and agency business of trust companies—were compiled. We also

undertook a number of special interview surveys of the financial position of individuals and their reactions to changes in monetary conditions, and of corporate, provincial government, and municipal government response to changing credit conditions. All these efforts gradually improved our understanding and led us to acquire new views on the problems with which our inquiry should deal and new ideas on the solutions which we might suggest to overcome them.

During the more than two years which we have devoted to our task, we have developed a certain underlying philosophy without which our report could not hope to have any measure of unity. First, in looking at our job we have tried vigorously to avoid being taken prisoner by the present. We have searched instead for a way of looking at the financial system and financial policies which—while relating them to current problems and developments—will have a continuing validity. We have sought a set of general principles and remedies rather than just a specific prescription for today's troubles which may be useless or even toxic tomorrow. In this search, we have not been moved to make recommendations for their own sake, to seek change on a wholesale scale, or to suggest the creation of new private or governmental institutions to meet particular needs not now being adequately served. On this last point we have preferred to recommend less sweeping modifications to existing practices, laws, or policies unless this would clearly not be a workable alternative. The ease with which one can create new institutions on paper is impressive, but we believed that more lasting success in closing gaps in the financial mechanism is apt to be achieved in practice by encouraging existing institutions to evolve in the directions desired by the community they service.

We also believe that Canadians want the basic freedom to arrange their financial transactions with a minimum of interference, and have approached our task in this light. On the whole, we have come to the conclusion that a freely functioning price system works well in allocating resources efficiently to desired uses. However, we do not regard free markets as an end in themselves, and we recognize that governments may wish to interfere with their functioning for broad social and political reasons—for example, to affect the level of economic activity, to alter the distribution of incomes in the community, to provide subsidies, or to close gaps that might otherwise exist in the financial system. Although we have not hesitated, therefore, to recommend modification of the free market system where its effects seem to be weak, uncertain or undesirable, we have felt that recommendations designed to make the market work better are generally to be preferred to the alternative approach of dealing with artificial barriers to the flow of funds by erecting a new set of barriers of our own. Similarly, where we have found indications of inadequate price competition, monopolistic practices, or potentially excessive concentration of financial power, we have tried to overcome them by suggesting measures designed to increase competition rather than by staking out new preserves from which certain types of institutions are excluded. However, we have no dogmatic devotion to any particular creed, and the basic test of the recommendations we have framed is whether they will contribute to the attainment of the broad economic goals sought by the Canadian public.

Finally, we have approached our task in the full recognition that we live in a federal state, that the financial requirements of different regions of the country vary in their character, and that the regulation of the financial system must always be to some extent divided between the national and provincial governments. While we have naturally been anxious to avoid excessive fragmentation in our financial system and while we have seen the need for more uniformity in certain areas, we have been equally anxious to avoid making recommendations which lead to over-centralization of the system. Since some of our recommendations may involve fine points of constitutional law, we have been content to point out in a broad way where it would seem that change is required in federal legislation and where our recommendations involve provincial law or co-operation between governments.

PLAN OF THE REPORT

We have laid out this report in three main groups of chapters. The first of these deals with the financial needs of the primary borrowers and lenders and the main sources of this finance. This set of four chapters deals respectively with personal finance, business finance, government use of the capital markets, and the role of foreign capital, and tries to point up some of the issues to which they give rise. The following group of chapters deals with the financial intermediaries and markets, describes their role in the economy and any deficiencies in their operations, and contains our main recommendations in this area. A general introduction of the broad institutional framework is followed by a series of chapters on the chartered banks, the Quebec Savings Banks, the caisses populaires and credit unions, and the trust and loan companies; next come chapters on the sales finance and personal loan companies, on the special credit facilities for smaller business, agriculture and exports and on the longer term investors—life insurance and investment companies and pension funds; these are followed by chapters on the mortgage market, the foreign exchange market, the bond and money markets, the stock market and securities regulation. We conclude in Chapters 18 and 19 with a number of broad recommendations designed to enhance the efficiency and competitiveness of the banking institutions and to modify the framework of regulation and supervision governing them.

The third part of the report deals with financial policy and its impact on the economy and the financial system. The first chapter deals with the objectives and record of policy, and we then turn to an assessment of the effectiveness and limitations of financial policies in a series of chapters on the effects of monetary policy and debt management on expenditure; on the techniques of monetary policy and debt management; on international financial policy; and on fiscal policy. Then come two chapters dealing with the choice and co-ordination of policy and with the role and responsibilities of the Bank of Canada within this broad policy framework. We conclude with a final brief assessment of the financial system and a summary of our main recommendations and reasoning, which have wherever possible been blended into the analysis and description of the unfolding report.

CHAPTER 2

PERSONAL FINANCE

The basic function of the financial system is to channel funds from economic units with surpluses—final lenders—to those with deficits—the final borrowers. Thus, before we turn to examine the financial institutions and markets, we will look briefly at the financial positions and needs of these ultimate borrowers and lenders and at their relationships with the financial system generally. We begin with the personal sector since it is the individual and collective wants of persons that the other categories of borrowers and lenders are ultimately designed to serve. After discussing the business and government sectors in the next two chapters, we conclude this part of the report with a brief analysis of the role of non-residents in supplying funds to, or absorbing them from, the domestic economy as a whole. It should be noted that the line between financial and non-financial economic units is not always distinct, some individuals or companies not primarily engaged in the financial business having extensive activities in financial assets and liabilities. It is nevertheless broadly accurate to think of non-financial units—the ultimate spenders in the economy—as being distinct from the financial intermediaries and markets.

The basic levels and patterns of spending by non-financial units in Canada, as in other countries, are of course influenced by many more basic factors than the type and nature of our financial system. However, our main concern must be with the lending and borrowing requirements of the main sectors of the economy—as determined by the decisions of the various units to consume, to invest, or to save—and with the question of whether the financial system serves these changing needs efficiently.

This, it should be emphasized, does not mean that borrowers are entitled to funds for unsound projects or that the rates they pay should always be low; nor, on the other hand, does it mean that lenders should always be entitled to high returns. It does mean, however, that there should not be excessive expense or difficulty involved in lending or investing funds and that the rate obtained or paid should fairly reflect both the risks and costs involved and competitive demands and offers in the financial markets. In general, the level of rates and the availability of funds in the economy as a whole ought to reflect underlying savings and investment trends and the amount of real resources available for use. Thus, if investment demand is relatively high, or the willingness to save relatively low, interest rates will tend to be high and vice versa. Similarly, rates will tend to be higher when real resources are fully employed, all other things equal, than they will when there is slack in the economy. We will be discussing these questions—and the influence of financial policy on spending—later in the report. Our principal focus in this section will be to review financing patterns in the economy and to look for any areas where the financial system fails to meet legitimate requirements efficiently and equitably, where it distorts spending or where it leads

to the discouragement of useful economic activity when real resources are lying idle.

Since consumers account for about two-thirds of national expenditure, the personal sector merits particular attention in any discussion of national sources and uses of funds. The rate of asset accumulation by households and the ways in which they hold their assets and incur liabilities have—like those of business—important implications for the rate, stability and composition of growth of the rest of the economy as well as for the welfare of the households themselves.

Households indeed resemble business enterprises in some ways; for example, they may meet their needs for many goods and services either by buying them or producing them. Like business, they benefit in their own production from using the method that involves the least cost. They produce a variety of services—shelter, restaurant, nursery, laundry, transportation, education, shopping, entertainment, to name a few.[1] The production of these services is facilitated by the use of capital goods, including consumer durables, and it is advantageous to employ such capital when its benefits exceed the cost of financing it even though the resulting production is not sold in the market place.

In addition to fixed capital, households normally maintain current assets in the form of liquid assets, accruals, and supplies; the accruals arise because of the periodic payment of salaries, wages, and investment income. Other external investments are held in quantity by households in the form of bonds, loans, shares, equity in unincorporated businesses and real estate as well as in life insurance and annuity or pension contracts.[2]

Like business enterprises, the household may finance its assets in several ways. Savings from current income, like business retained earnings, are the main source of household investment funds. Monthly charge accounts, like trade credit, comprise a flexible source of funds which provides advantages by separating purchasing from paying activities. Households, too, make extensive use of instalment, medium and long-term credit, especially when fixed assets are purchased. Where borrowing raises real income, savings as well as consumption may increase.

Chart 2-1 shows the absolute level of net personal saving in Canada in the post-war period (excluding accumulations of farm inventories) and also indicates its relationship to personal disposable income—i.e. personal income after taxes. Although the personal saving figure (which is arrived at after deducting the sector's own spending on durables) is a residual and subject to fairly large errors of estimation, and although there are sizable year to year variations in the total, the chart indicates that personal saving has shown a substantial growth over the period. Sharp drops in both the absolute amount and rate of saving occur in years of strong consumer demand like 1947, 1950 and 1955, but over a longer time-span the average saving rate works out to between 6.5% and 7.0% of disposable income. (For the period as a whole the rate was 6.6%, for 1957-62 it was 6.8%). These figures are broadly comparable to those in the United States and higher than in many other countries, and do not support the contention that Canadians save at a relatively low rate. The current rate is, however, below the abnormally high level in the immediate post-war years, when savings rates may have been affected by shortages.

It is interesting to note that net personal saving has contributed about a quarter of the total financing of business capital investment and net government requirements in the post-war period.[3] The balance has been met either from the internal earnings of the business sector itself or from non-residents. In the early post-war years, when saving was high, governments were in substantial surplus and business investment was low in relative terms, the ratio of personal saving to the total was

[1] Except for the rent imputed to owned houses, these services do not enter into the reported totals of the G.N.P., however.

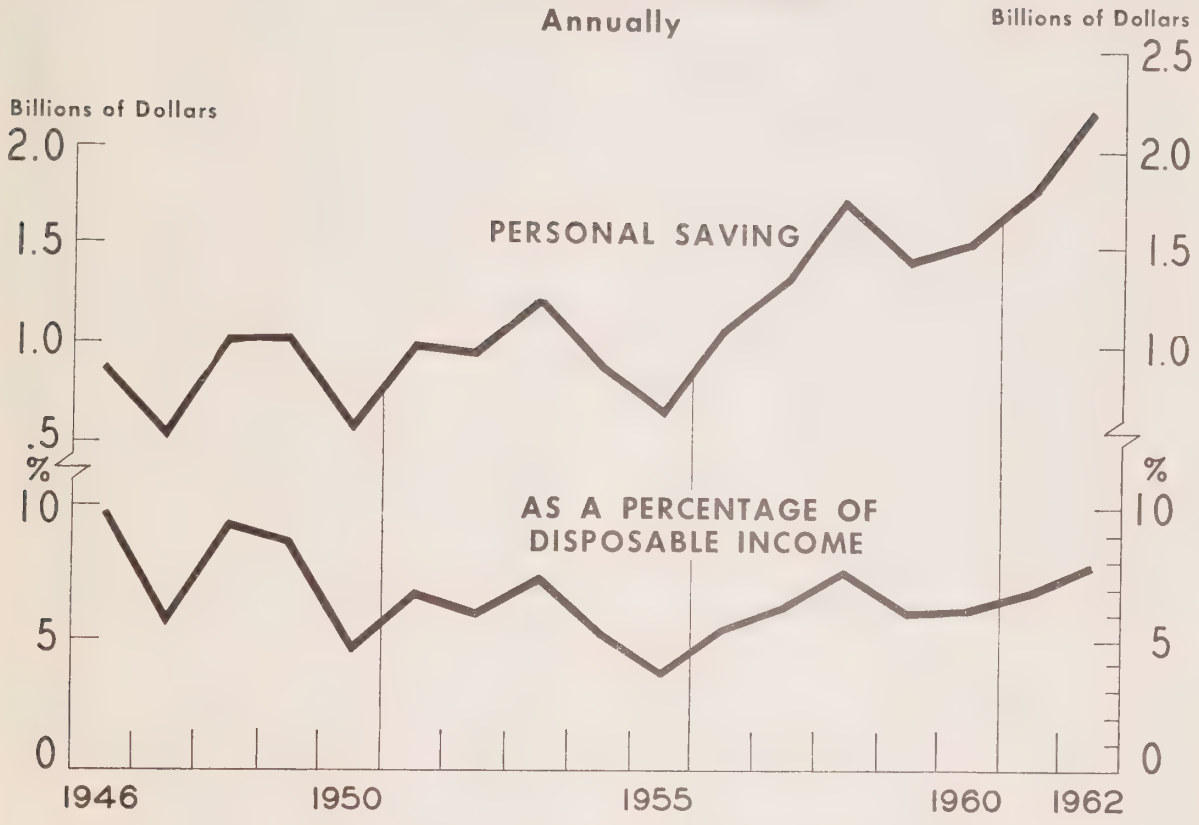
[2] A unique asset of the household is the present value of the prospective labour service to be supplied by its members. It can be many times the magnitude of financial assets and can offer the prospect of "capital appreciation" until retirement.

[3] Included are investment in fixed assets, inventory accumulation, housing expenditures and government deficits or surpluses; in years when governments ran surpluses, they have been subtracted from the total.

Chart 2-1

NET PERSONAL SAVING[1]

Annually



1. As in the National Accounts, excluding the change in farm inventories.

unusually high, averaging over 40%. After averaging about 20% from 1950 to 1954, the ratio dropped sharply to 13% in 1955 and 1956. In these years, moderate government surpluses were reducing the total to be financed, but business investment was unusually high. This high investment, combined with low personal saving, helps to explain why the use of non-resident funds expanded so much in those years. From 1958 to 1962 sizable government deficits emerged, but the ratio rose again to close to 25%, reflecting rising personal saving and some decline in business investment. Thus, net personal saving continues to be a significant source of funds for other sectors of the economy.

THE FINANCIAL POSITION OF HOUSEHOLDS

The broad trends of consumer finance in the post-war period are well-known: consumers emerged from the war with large amounts of cash and liquid assets, mainly in the form of government bonds, as the counterpart of war finance. They also had unusually low levels of consumer debt, primarily as the result of high wartime incomes combined with shortages of consumer durable goods. Thus, consumer debt in 1946 amounted to only $388 million or 4.5% of personal disposable income while residential mortgages outstanding were well under $1 billion. This situation altered dramatically as a result of buoy-

ant post-war economic conditions and incomes and the need to satisfy the demands deferred by depression and war. Changing technology and a shortage of labour also contributed to the process and ownership of television sets, record-players, home laundry equipment and many other durable items consequently expanded significantly. Thus consumer debt rose eleven-fold in amount to 16.2% of disposable income in 1962 while the growth of home building and ownership caused residential mortgage debt to climb to over $10 billion. This process was greatly aided by increased competition among the lending institutions and by the development of new lending techniques which—by reducing the risk of lending—made credit available to a broad sector of the population previously not considered credit-worthy.

While the main features of this striking growth in household physical assets—and its accompanying increase in debt—are clear enough, there is a large statistical gap on the details of consumers' financial assets and liabilities. We hope that the federal authorities will give priority to the important task of creating a systematic set of accounts which will reveal detailed flows and holdings of financial assets by category and sector. In the absence of such data, we undertook a survey of household finances which was carried out for us by a private firm working with our staff and in co-operation with officers of D.B.S., whose valuable advice and assistance we wish to acknowledge. Interviews were conducted in seven metropolitan areas in five provinces with the use of an extensive questionnaire, and replies were obtained from 1,221 households.[4] Although we were unfortunately not able to study all the information received in the time available, and although the survey necessarily had to dwell on recent developments rather than those in the post-war period as a whole, we have used the results as the basis of much of the description and analysis that follows.

As the last lines of Tables 2-1 and 2-2 indicate, the average household surveyed had an income of about $5,900, assets of almost $20,500, debts of $3,600 and a net worth of $16,800. On the asset side, these figures exclude the value of household durables and furnishings and of life insurance and annuities not in the form of withdrawable pension credits; they also exclude holdings of currency, which is a minor item. On the liabilities side, charge accounts are excluded; on the basis of other data these would amount to less than $100 per household. While it is difficult to put values on household equipment and life insurance, data obtained from the survey and other sources indicate that the value of automobiles per household was just over $1,000 and that of seven other major durables was well in excess of $300. On the basis of national data, the value of paid-up life insurance and annuities was about $1,150 per household. Thus, if one adds these figures and the value of other home furnishings to the total, assets per household rise to nearly $23,000 and net worth to over $19,000. These results should be broadly accurate since the sample was carefully designed to be representative of the urban population; however, some errors and omissions are bound to occur, and some items appear to have been seriously understated. Where the results differ from other available information, we shall draw attention to these differences.

There was a large variation within these totals, with some 5% of households reporting that they held none of the assets covered in the survey, and 3% holding assets of $100,000 or more.[5] Nevertheless, a fairly consistent pattern emerges from the tables. The higher the income of households—and thus the greater was their ability to save and to service debt—the larger were their assets, debt and net worth. Moreover, the pattern was closely related to the age of the household head: assets rise up to retirement age and then fall, although net worth continues to expand slowly. Debt, on the other hand, reaches a peak in the 40 to 49 age bracket as fixed assets are still being accumulated and children are being educated. As the younger members of the family enter the labour force and move from home, debt subsequently falls quite sharply, both because of

[4] A detailed description of the survey, and its results, will be found in the appendix volume.

[5] No households reported debts of this amount, and only 0.1% reported debt of $50,000 to $99,999.

TABLE 2-1

DISTRIBUTION AND SELECTED CHARACTERISTICS OF HOUSEHOLD, BY LEVEL OF INCOME AND TOTAL ASSETS, SEVEN METROPOLITAN AREAS,[a] LATE 1962

	Percent of Total Households	Average per Household					
		Assets[b]	Debts[c]	Net Worth	Income $	Members No.	Age of Head Years[d]
1961 Income—$							
Under– 3,000	15.2	3,977	574	3,402	1,911	2.4	49
3,000– 4,999	32.1	8,968	1,772	7,196	4,064	3.4	42
5,000– 6,999	24.9	15,422	3,927	11,494	5,764	3.6	43
7,000– 9,999	16.6	29,644	6,162	23,483	8,126	3.7	45
10,000–14,999	7.0	47,031	8,053	38,978	11,490	4.0	47
15,000 and over	3.1	143,904	9,858	134,047	23,272	4.0	49
Total Assets—$							
0	5.3	—	280	−280	2,513	2.9	47
1– 999	20.0	317	346	−29	3,764	3.5	39
1,000– 4,499	13.8	2,310	251	2,059	4,663	3.1	40
4,500– 7,499	4.0	5,682	449	5,233	4,863	3.0	44
7,500– 9,999	2.4	8,424	1,089	7,335	4,738	3.1	47
10,000–14,999	9.4	12,574	3,676	8,898	4,768	3.7	46
15,000–24,999	25.2	19,151	5,735	13,416	6,431	3.5	46
25,000–49,999	13.4	33,675	7,496	26,179	8,428	3.7	48
50,000–99,999	3.8	69,183	5,553	63,631	10,353	3.2	53
100,000 and over	2.8	233,790	15,441	218,349	17,587	3.4	53
TOTAL[e]	100.0	20,421	3,591	16,830	5,910	3.4	45

[a]Halifax-Dartmouth, Montreal, Quebec, London, Toronto, Winnipeg, and Calgary.
[b]Includes deposits, bonds, loans, shares, equity in own business, rental real estate and owned homes (including country residences).
[c]Mortgages, instalment loans, and other loans, exclusive of charge accounts.
[d]Age group only was reported. Average is based on representative ages as shown in top part of Table 2-2.
[e]Includes 1.0% of total households not classified by income level.
SOURCE: Royal Commission on Banking and Finance; *Consumer Survey*, 1962.

contractual repayment obligations under mortgage and instalment loans and because rapid repayment is attractive on cost and taxation grounds.[6] Occupational or size of household classifications do not affect this pattern, although they do influence the size of the household's income, assets, debt and net worth.

A more detailed distribution of household assets and liabilities appears in Tables 2-3 and 2-4. Liquid assets are defined as deposits of all kinds and Canada Savings Bonds, while the classification "other cash-producing investments", includes all other bonds, loans receivable, shares, equity in private businesses and income-producing real estate. Obviously, these latter investments possess liquidity in varying degrees, but we have felt justified in treating them separately; accumulated pension rights and interests in estates are treated as another separate category. On the debt side of the balance sheet, all non-mortgage debt requiring monthly payments is classified as instalment debt, with the balance of non-mortgage debt in the "other debt" classification.

The table shows owned homes (including country residences) are the most important category of assets held, accounting for 49% of all reported assets. If we had been able to calculate the value of furniture and durables, the proportion of assets associated with home ownership might have been even higher, even allowing for the value of other

[6] Since implicit rent on home ownership is not taxable, it is usually advantageous to sell fixed-income securities—even if the gross yield is high—to pay off a mortgage, the interest on which must be paid out of post-tax income. This is especially true in higher tax brackets.

TABLE 2–2

DISTRIBUTION AND SELECTED CHARACTERISTICS OF HOUSEHOLDS, BY AGE AND OCCUPATION OF HEAD OF HOUSEHOLD, SEVEN METROPOLITAN AREAS,[a] LATE 1962

	Percent of Total Households	Average per Household					
		Assets[b]	Debts[c]	Net Worth	Income $	Members No.	Age of Head Years[d]
Age– Years							
29 and Under	13.9	5,977	1,949	4,027	4,605	3.0	25
30 to 39	28.5	14,728	4,662	10,066	6,098	3.9	35
40 to 49	24.0	23,726	4,860	18,867	6,488	4.0	45
50 to 64	24.5	29,317	3,046	26,271	6,234	3.0	57
65 and Over	9.1	27,598	856	26,742	4,909	2.1	70
Occupation							
Professional	9.1	31,678	5,508	26,170	9,395	3.7	42
Business Executive	10.5	64,049	8,067	55,982	9,683	3.7	44
Clerical	13.0	12,450	2,550	9,899	5,529	3.0	42
Sales	7.2	18,393	5,246	13,147	6,332	3.8	43
Skilled Labour	35.8	12,301	3,015	9,286	5,321	3.6	42
Unskilled Labour	10.3	7,376	2,385	4,990	4,007	3.5	45
Retired	5.5	23,878	764	23,113	4,316	2.3	68
Other	8.5	16,505	1,833	14,672	3,623	2.9	50
TOTAL	100.0	20,421	3,591	16,830	5,910	3.4	45

See Table 2-1 for footnotes and source.

omitted assets mentioned earlier, i.e. life insurance and ordinary annuities. The higher the income level, the less important was home ownership in the total, reflecting the tendency of those with high earnings to accumulate substantial quantities of financial assets. Similarly, the home was the dominant holding of all those with total assets in the $7,500 to $50,000 range, while above this range wealth was increasingly devoted to income-producing assets. As expected from the pattern of family needs for housing, home ownership increases in importance until early middle age and declines thereafter. As the table also shows, investment in their own home represents a particularly large proportion of the assets of labour, clerical, and sales occupations of all age groups, presumably mainly because their income levels do not enable them to invest heavily in financial assets.

Liquid assets accounted for about 11% of gross wealth, the proportion—but not the absolute amount—of such holdings tending to decline with income. Other income-producing assets, on the other hand, rose in importance as incomes increased: the highest income group held over two-thirds of their assets in this form compared to 35% for the sample as a whole and to only one-tenth for the lowest income group. There was also a correlation between holdings of these assets and total wealth, occupation and age—the only exceptions being in the categories where home ownership became particularly important and in the oldest age group, which appears to hold a somewhat higher proportion of liquid assets to meet emergencies. Interest in estates, trusts and pension funds account for under 6% of reported assets, but with the spread of compulsory pension plans, especially for new employees, have become a significant proportion of the assets of younger households which have not accumulated large amounts of other wealth.

This broad pattern of investment appears to reflect the basic needs of households. After accumulating their own home and equipment, increasing amounts are devoted to financial investment, but those with small sums to invest find it

TABLE 2–3

DISTRIBUTION OF BALANCE SHEETS OF HOUSEHOLDS, BY LEVEL OF INCOME AND TOTAL ASSETS, SEVEN METROPOLITAN AREAS,[a] LATE 1962

	Assets %[b]					Debts[c] and Net Worth as % of Assets					
						Mortgages					
	Liquid[d]	Other Cash Producing[e]	Pensions, Trusts, Estates[f]	Owned Homes[g]	Total $	Owned Homes[g]	Rental Property	Instalment[h]	Other	Total	Net Worth
1961 Income—$											
Under– 3,000	18.8	10.2	1.0	70.1	3,977	7.8	—	4.0	2.1	13.9	86.1
3,000– 4,999	13.8	20.2	4.6	61.4	8,968	15.8	0.2	2.9	0.8	19.8	80.2
5,000– 6,999	11.8	21.5	7.3	59.4	15,422	19.3	1.9	1.7	1.3	24.2	75.8
7,000– 9,999	10.0	26.1	5.1	58.8	29,644	17.0	1.4	1.0	1.4	20.8	79.2
10,000–14,999	8.7	35.9	11.4	44.0	47,031	12.0	3.2	0.8	1.1	17.1	82.9
15,000 and over	7.0	68.3	2.3	22.3	143,904	5.0	0.8	0.7	0.9	7.3	92.7
Total Assets—$											
0	—	—	—	—	—	—	—	—	—	—	—
1– 999	82.5	2.6	14.7	0.2	317	—	—	93.4	15.8	109.2	−9.2
1,000– 4,499	51.7	10.9	33.3	4.1	2,310	—	—	9.4	1.4	10.9	89.1
4,500– 7,499	43.7	28.0	15.2	13.2	5,682	—	—	5.2	2.6	7.9	92.1
7,500– 9,999	21.9	19.0	6.8	52.3	8,424	7.7	—	3.2	2.0	12.9	87.1
10,000–14,999	9.7	7.4	3.9	79.0	12,574	26.6	0.1	2.1	0.4	29.2	70.8
15,000–24,999	7.8	5.4	4.8	81.9	19,151	27.1	0.4	1.4	1.1	29.9	70.1
25,000–49,999	12.5	17.8	5.7	64.1	33,675	18.5	1.2	0.7	1.9	22.3	77.7
50,000–99,999	13.2	44.8	5.6	36.4	69,183	4.8	2.2	0.4	0.6	8.0	92.0
100,000 and over	6.1	72.7	4.3	16.9	233,790	2.4	3.1	0.3	0.8	6.6	93.4
Average per Household[i] %	10.6	35.2	5.5	48.8	100.0	13.5	1.6	1.3	1.1	17.6	82.4
" " $	2,156	7,183	1,118	9,964	20,421	2,752	331	274	234	3,591	16,830

[a], [b], [c], See Table 2-1. [d]Deposits and Canada Savings Bonds. [e]Other bonds, loans, shares, equity in own business, rental real estate. [f]Withdrawable pension credits, and asset and asset-income interests in trusts and estates. [g]Includes country residences. [h]Non-mortgage loans which require monthly payments. [i]Includes 1.0% of total households not classified by income level.

SOURCE: Royal Commission on Banking and Finance, *Consumer Survey*, 1962.

time-consuming, costly and risky to manage complicated portfolios. They thus tend to pay off debt or to accumulate relatively riskless liquid assets. Those with larger resources, however, can take bigger risks, are in a better position to obtain the advice of professional real-estate or investment men, and have lower costs per dollar of investment. Once sufficient liquid assets are accumulated, therefore, it becomes worthwhile for higher income groups to obtain higher returns on their funds; this is not necessarily the case for a household with, say, under $500 to invest. Moreover, people in these higher income groups have somewhat fewer difficulties in investing in less liquid assets because of their knowledge of corporate life, financial affairs or real estate. Thus accountants and business executives are familiar with financial statements, and lawyers and contractors are frequently skilled in property evaluation and transfer. Finally, those who have retired have more time to investigate and assess investments than do others. It is not surprising, therefore, that professional, executive and retired persons have high proportions of their assets in less liquid form.

In spite of the widespread concern over the rise of household indebtedness, the tables indicate that the average household reports total debt equivalent to only 18% of assets. As noted earlier, certain assets appear to be under-reported; this also appears to be the case with non-mortgage debt, but if allowance is made for these omissions, the proportions nevertheless appear to be broadly accurate. Reflecting the importance of investing in housing, over three-quarters of total reported

TABLE 2–4

DISTRIBUTION OF BALANCE SHEETS OF HOUSEHOLD BY AGE AND OCCUPATION OF HEAD OF HOUSEHOLD, SEVEN METROPOLITAN AREAS,[a] LATE 1962

	Assets %[b]					Debts %[c]					
						Mortgages					
	Liquid[d]	Other Cash Producing[e]	Pensions, Trusts, Estates[f]	Owned Homes[g]	Total $	Owned Homes[g]	Rental Property	Instalment[h]	Other	Total	Net Worth
Age— Years											
29 and under	12.3	27.9	15.5	44.3	5,977	21.5	0.3	6.5	4.3	32.6	67.4
30 to 39	8.2	27.1	4.5	60.2	14,728	26.4	1.2	2.2	1.9	31.7	68.3
40 to 49	7.1	31.7	6.2	55.0	23,726	16.3	2.0	1.1	1.0	20.5	79.5
50 to 64	12.0	42.5	3.7	41.8	29,317	6.6	2.2	0.8	0.8	10.4	89.6
65 and over	17.7	38.0	7.2	37.1	27,598	2.4	0.3	0.2	0.3	3.1	96.9
Occupation											
Professional	11.2	34.7	4.4	49.7	31,678	13.3	1.3	1.2	1.5	17.4	82.6
Business Executive	6.1	59.2	5.2	29.6	64,049	8.3	2.3	0.9	1.2	12.6	87.4
Clerical	16.9	15.0	8.7	59.4	12,450	17.8	—	1.9	0.8	20.5	79.5
Sales	11.8	20.6	5.5	62.1	18,393	22.5	2.8	1.6	1.6	28.5	71.5
Skilled Labour	10.9	16.8	4.9	67.4	12,301	18.8	2.2	2.2	1.2	24.5	75.5
Unskilled Labour	12.3	4.8	4.5	78.5	7,376	28.1	0.8	2.4	1.1	32.3	67.7
Retired	17.5	41.5	0.2	40.8	23,878	2.3	0.1	0.3	0.5	3.2	96.8
Other	13.8	27.5	12.3	46.4	16,505	9.8	—	0.6	0.6	11.1	88.9
Average per Household[i] %	10.6	35.2	5.5	48.8	100.0	13.5	1.6	1.3	1.1	17.6	82.4
" " $	2,156	7,183	1,118	9,964	20,421	2,752	331	274	234	3,591	16,830

See Table 2-3 for footnotes and source.

indebtedness of $3,591 was in the form of mortgages on households' own homes. While mortgage debt was of major importance to the majority of those who had recently bought a new home, it is interesting to note that on average it is equivalent to just under 30% of the reported value of homes owned. Comments made by some respondents indicated that the availability and cost of mortgage funds tended to limit their use of this form of financing.[7] As the figures show, this debt is generally highest in categories in which home ownership is particularly important, although even in the youngest age group it does not account for quite 50% of the reported value of housing; in the oldest age group, repayments have reduced mortgage debt to a very small proportion of the value of the home.[8]

The remainder of reported debt was over half in the form of instalment debt, the balance being bank loans or other indebtedness which did not call for monthly repayment. However, even if one includes charge accounts—which would add about $100 per household to the reported non-mortgage debt figures, and would bring the total to over $600 per household—the survey appears to have seriously understated this personal debt. A compilation of personal debt based on the outstanding accounts of banks, other financial institutions and retail credit puts the total at over $900 per household on an average basis. Some of this latter debt is undoubtedly incurred for business or farm purposes—and is thus excluded from our survey—but it nevertheless appears that our results on non-mortgage personal debt are about $200 per household lower than might be expected. We do not know whether this was due to sampling error or—more likely—to omission or understatement on the part of respondents. The error appears to

[7] Our analysis of the mortgage market, and our recommendations for improvements, will be found in Chapter 14.

[8] Mortgage debt on income-producing real estate is less than 2% of average assets, although equal to about 22% of the value of such real estate. See Tables 2-3 and 2-9.

lie almost entirely in the reported figures for instalment debt, which—on the basis of national averages—should have been almost twice the reported figure of $274 per household. Assuming the error is evenly distributed by category, it would thus roughly double the percentages of instalment debt shown in the tables.

Instalment debt is found in 32% of households and at all income levels, although its highest relative use is found in the lower income categories where the reported figure runs as high as 4% of assets, and in the under-29 age group where it is equal to almost 7% of reported assets. In higher income categories its relative use—although not its absolute amount—declines. In the higher age categories, both its relative and absolute use declines. Clerical and labouring personnel use instalment debt most frequently, although it is not as high as 3% of assets in any occupational category. Those with the smallest amounts of reported assets also make heaviest use of consumer credit—partly because of the absence of any other collateral. It will be recalled that the values of durable goods are not included in the reported asset total, a fact which helps to account for some 5% of households reporting no assets, yet also reporting instalment and other debts of $280 per household. (See Table 2-1).

The total reported indebtedness of all income, age, occupational and asset groups—other than the category reporting no assets or assets under $1,000—in no case exceeds one-third of the value of assets. Most of this debt—about four-fifths in all—is associated with home ownership and the purchase of durables, but in some cases it is connected with the acquisition of income-producing assets. Examples include the buying or renovation of rental properties, the purchase of Canada Savings Bonds, acquisition of company shares on stock option plans, the buying of securities on margin, and the pledging of personal assets to raise funds for private businesses. However, the survey indicated that the vast majority of reported borrowing was for purposes connected with the purchase of housing or consumer durable goods. Even allowing for the understatement of instalment debt noted above, the survey does not indicate that consumers generally are in an over-extended financial position. Indeed, a large part of the repayment commitments incurred with such debt merely displaces previously unrecorded, but nevertheless real, commitments for monthly rent, laundry, or other services. This is not to argue that there are not some households in an over-extended position, either owing to poor financial planning or over-purchasing, but merely to state that the overall position of households does not suggest weak management or a vulnerable financial position. In fact, the survey showed that 50% of households had no instalment or mortgage debt, a further 29% had repayment commitments equal to under 10% of income and that 2% had repayment commitments equal to between 30% and 49% of income.[9]

It is not possible to value Canada's stock of owner-occupied dwellings, durables and house furnishings with any precision, although data on home ownership and the possession of certain durable goods is shown in Table 2-5. After allowing for durables owned by landlords and supplied with rented premises, and making conservative estimates of the depreciated value of the durable goods, it is probable that the value of owner-occupied homes, equipment and automobiles amounts to more than $8,000 for every household in Canada, or over $35 billion; of this sum, housing might account for $25 billion. This may be compared with a total of under $20 billion for all federal debt outstanding or a gross value of under $30 billion for all listed Canadian equity securities.

The size of this extensive investment in household fixed assets raises the question of whether, from a purely economic point of view, it is soundly-planned. Obviously, the answer must be in part a subjective one, since it will depend on basic consumer preferences for goods and services and for home-ownership and its accompanying freedom and responsibilities. Broadly speaking, however, favourable returns were realized in the post-war period on investment in owned homes

[9] See the appendix volume for details. It might be noted that the few households in this category reported substantial amounts of net worth.

TABLE 2–5

INCIDENCE OF SELECTED HOUSEHOLD DURABLE GOODS BY TYPE OF DURABLE, MAY, 1962

Durable	Households with	
	Number '000	As % of Total Households[a,b]
Owner occupied dwelling	3,103	67.6
Automobile	3,248	70.7[b]
Electric Refrigerator	4,285	93.3
Home Freezer	716	15.6
Automatic Dishwasher	78	1 7
T.V. Set	3,979	86.7[b]
Cooking Equipment[c]	4,562	99.3
Clothes Dryer	849	18.5
Electric Washer	3,979	86.7
Outboard motors	376	8.2
Phonograph or Record Player	2,328[d]	50.7
Radio[e]	4,413	96.1[b]

[a]Total number of households was 4,592,000.

[b]Treating households with two or more automobiles or television sets as possessing two, the average number per household was 0.80 for automobiles and 0.92 for television sets. Treating households with four or more radios as possessing four, the average number per household was 1.47.

[c]Excludes 17,000 households with such equipment as hot plates and sawdust burners.

[d]There were 1,239,000 cabinet models, 285,000 table models and 804,000 portable models.

[e]Excludes car radios.

SOURCE: D.B.S. *Household Facilities and Equipment, May, 1962.* (Ottawa, Queen's Printer, 1962)

as both rents and housing prices rose substantially. To the extent that mortgage debt was incurred, the owner obtained relatively larger capital gains on his own equity. In fact, more households realized capital gains in the housing market than in the stock markets. Although other factors are also at work, it is almost certainly true that some of the recent increase in relative demand for rental accommodation is associated with more stable housing prices and the consequent realization that home ownership has not been as attractive as formerly.

Investment in household equipment returns a substantial part of its yield in terms of reduced labour and increased convenience for the housewife or—in the case of automobiles, television sets and record-players—increased enjoyment. Returns can, however, also be calculated in monetary terms—e.g. in the case of television sets, the money saved on baby-sitters' fees and outside entertainment; in the case of home laundry equipment, returns can be calculated in terms of the saving on laundromat bills. Recent studies indicate that such returns can be substantial—even when no allowance is made for savings of the housewife's time and energy—that investment in durable goods can therefore be justified in purely economic terms, and that household borrowing for such purposes is rational and "productive".[10] While not wanting to push this argument too far, we find this an interesting and by no means unreasonable point of view.

LIFE INSURANCE, ANNUITIES AND PENSIONS

By purchasing life insurance and annuities, the value of which is not shown in the tables, Canadians delegate a large proportion of their task of investing in cash producing assets to life insurance companies. In the post-war period the absolute annual volume of life insurance savings has grown almost without interruption, there being a decline in just one year and then by only $1 million.[11] Such savings ranged from 19% to 53% of net annual personal savings (excluding investment in consumer durables) in the period 1946-60; they ranged from 24% to 32% in 1956-60. However, an increasing share of life insurance and annuities are being acquired through employers on a collective basis.[12]

Purchases of life insurance and annuities made directly from insurance companies by individuals are larger in relation to income at high than at low levels of household income (Table 2-6). For non-farm households in 1958 the proportion of

[10] See study prepared by Professor J. V. Poapst and W. R. Waters at the School of Business, University of Toronto, 1963, manuscript. They assume that each hour of television entertainment is worth only 15% of an hour of outside entertainment, and further assume average Toronto viewing habits. On this basis, they show that a set owned for six years would return 38% annually on a discounted basis, after expenses, in terms of the reduced cost of outside entertainment, including admission, transportation and baby-sitter costs.

[11] The Canadian Life Insurance Officers Association, Submission, p. 32. Personal saving has been adjusted to exclude the change in farm inventories.

[12] *Ibid.* pp. 19 and 21.

TABLE 2-6

LIFE INSURANCE AND ANNUITY PREMIUMS PAID TO LIFE INSURANCE COMPANIES[a] BY NON-FARM FAMILIES AND UNATTACHED INDIVIDUALS, BY INCOME AND AGE, 1958

Families and Unattached Individuals			Families			
1958 Income—$	Average Premium[a] $	Premium as % of Income[b]	Age of Head—Years	Average Premium[a] $	Average Income $	Premium as % of Income[b]
Under 3,000	29	1.8	29 and Under	108	4,210	2.6
3,000–4,999	98	2.5	30 to 39	153	4,929	3.1
5,000–6,999	160	2.7	40 to 49	176	5,622	3.1
7,000–9,999	218	2.7	50 to 64	136	5,307	2.6
10,000 and over	541	3.6	65 and over	91	3,830	2.4
TOTAL[c]	116	2.6	TOTAL	139	4,921	2.8

[a]Excludes payments to employee pension plans.
[b]Figures are based on average income for each interval.
[c]Average 1958 income was $4,544.
SOURCE: D.B.S., *Incomes, Liquid Assets and Indebtedness of Non-Farm Families in Canada, 1958;* and correspondence.

income spent in this way was twice as high for households with incomes of $10,000 and over (3.6%) as for those with incomes under $3,000 (1.8%). This relationship reflects in part the effect of household size, which also increases with income. It also reflects income tax incentives to the financing of retirement savings. Subject to limits, individual annuities may be registered for the deduction of some or all payments from taxable income. Progressive income tax rates mean that the inducement increases with income.

Households headed by persons in their 30's and 40's spend more of their income on life insurance and individual annuities than those headed by younger or older persons. Households in which the head is under 30 are smaller than those in which the head is in his 30's or 40's, retirement is further away and the question of financing it less pressing. The greater size of households headed by persons in their 30's and 40's (as indicated by households in seven metropolitan areas in 1962) means a greater demand for insurance to protect and provide for the family. In addition, the period before retirement is shorter, and payments for any type of level premium insurance or for an annuity at a given age of retirement are higher. Subsequently, the decline in household size reduces the demand for life insurance, and there is a shift from paying to receiving insurance moneys as endowments mature, cash options are exercised and annuity payments begin.

Canadians are reported to hold more life insurance in relation to their income than the people of any other country, partly because of high per capita income and our relatively well developed agency system. However, if allowance is made for the large amount of survivorship benefits provided to Americans under the Old-Age Survivors and Disability Insurance Program, the ratio of life insurance in force to personal income would be 270% in the United States compared to 171% for Canada.[13]

Employee pension rights are also widely held household assets. In the seven metropolitan areas, 38% of the households were found to be contrib-

[13] Source of data used in the calculations: U.S. Department of Health, Education, and Welfare, *Estimated amount of life insurance in force as survivor benefits under OASI, 1959-60,* Actuarial Study no. 54. An additional $43 billion of life insurance in force, the equivalent of 8% of private insurance, was provided under the Veterans' Plan.

uting to pension plans in addition to those currently on pension. The spread of compulsory plans and income tax and other incentives to membership have been in part responsible for the rapid post-war growth of pension plans, which have now become an important source of personal savings and are responsible in part for the tendency for personal life insurance purchases to be concentrated increasingly in term forms. Total assets of trusteed plans, together with the assets associated with life company and government group annuities, amounted to $6,081 million in 1961, and during that year the book value of assets rose by $657 million, an amount equal to one-half of net personal saving.[14]

The accumulation of compulsory savings in pension funds may pose problems for some households which would prefer to invest instead in fixed assets and to leave retirement saving until later. However, the fact that most households buy additional life insurance and that the pressure on firms to initiate pension plans has come mainly from employees suggest that this pattern of saving is preferred by the vast majority of households. To most, the pay-roll deduction of pension contributions probably represents a convenient and relatively painless way of giving effect to their strong desire for security without impinging too heavily on current standards of living.

LIQUID ASSETS AND OTHER CASH PRODUCING INVESTMENTS

Of the $20,421 of assets reported by the average household in the survey, some $7,183 per household, or 46% of total reported assets, were in liquid or other cash-producing investments.[15] Of this sum, about one-quarter was in liquid form and the remainder in other forms of debt, equity and income-producing real estate. On the basis of other available data, however, both the deposit and Canada Savings Bond holdings of the average household appear to be under-reported, perhaps by as much as one-third; the deposit total should average well over $2,000 rather than $1,400 per household judging by the liabilities of the financial institutions, while C.S.B. holdings should be closer to $900 per household than $731.[16]

As can be seen from Tables 2-7 and 2-8, debt instruments (other than deposits and C.S.B.'s) were only 12% of the total shown, although this figure too may be somewhat under-reported, with holdings of bonds somewhat less than those in mortgages and other loans (See Tables 2-9 and 2-10). Equity investments were by far the largest of the assets shown, accounting for almost two-thirds of the total; more than one-half of this investment was in businesses owned by the households. A further large part of equity investment was represented by ownership of income-producing real estate, which exceeded investment in publicly traded shares. Shares in investment funds and other pooled holdings, at less than 2% of the total, were the smallest type of liquid and cash-producing investment.

Some of the reasons for the broad pattern of holdings of liquid assets have already been discussed. For the sample as a whole, two-thirds of liquid assets were held in the form of deposits in financial institutions and the balance in Canada Savings Bonds. There was a tendency for low-income and unskilled occupational groups to hold relatively small amounts of savings bonds in relation to deposits; this was also true of younger households or those with assets under $7,500. With lower incomes and asset holdings, presumably relatively more of the liquid assets owned are required for transactions purposes; moreover, the small amounts available for investment in savings bonds may not make it worthwhile to buy them. These groups also make relatively heavy use of instalment credit and there is an apparent tendency to reduce such debt rather than accumulate low-yielding bonds. When it would be advantageous to substitute savings bonds for cash, these groups, because of less knowledge and experience

[14] D.B.S. *Trusteed Pension Plans, Financial Statistics, 1961.*

[15] Cash-producing investments are defined to include all assets other than owned homes, liquid assets and interests in pension funds, trusts and estates. See Table 2-4.

[16] After allowing for holdings by estates. The low deposit figure may well result from the fact that respondents have deducted cheques issued which had not yet been cleared against their accounts.

TABLE 2–7

DISTRIBUTION OF LIQUID AND OTHER CASH PRODUCING ASSETS OF HOUSEHOLDS, BY LEVEL OF INCOME AND TOTAL ASSETS, SEVEN METROPOLITAN AREAS[a], LATE 1962

(Per Cent)

	Other Cash Producing			Total	
	Liquid	Debt	Equity	As % of all Assets	Per Household—$
1961 Income–$					
Under– 3,000	68.0	15.1	17.0	29.0	1,153
3,000– 4,999	41.4	13.3	45.2	34.0	3,049
5,000– 6,999	34.5	14.2	51.3	33.3	5,136
7,000– 9,999	27.6	6.1	66.3	36.1	10,701
10,000–14,999	19.5	7.6	73.0	44.6	20,976
15,000–and over	9.2	13.4	77.4	75.3	108,360
Total Assets–$					
0– 999	96.9	1.8	1.2	85.1	270
1,000– 4,499	82.5	4.4	13.2	62.6	1,446
4,500– 7,499	61.0	10.8	28.4	71.7	4,074
7,500– 9,999	53.6	8.6	37.8	40.9	3,445
10,000–14,999	56.9	9.3	33.9	17.1	2,150
15,000–24,999	59.0	6.8	34.1	13.2	2,528
25,000–49,999	41.2	17.9	40.8	30.3	10,204
50,000–99,999	22.8	10.5	66.7	58.0	40,126
100,000 and over	7.8	12.5	79.8	78.8	184,227
Average per Household ..... %	23.1	12.2	64.8	45.8	9,339
" " ..... $	2,156	1,139	6,044		

For footnote and source see Table 2–1

TABLE 2–8

DISTRIBUTION OF LIQUID AND OTHER CASH PRODUCING ASSETS OF HOUSEHOLDS, BY AGE AND OCCUPATION OF HEAD OF HOUSEHOLD, SEVEN METROPOLITAN AREAS, LATE 1962

(Per Cent)

	Other Cash Producing			Total	
	Liquid	Debt	Equity	As % of all Assets	Per Household–$
Age of Head–Years					
29 and under	30.6	6.8	62.6	40.2	2,403
30 to 39	23.2	4.7	72.1	35.3	5,199
40 to 49	18.3	5.7	76.0	38.8	9,206
50 to 64	22.0	13.7	64.4	54.5	15,978
65 and over	31.8	27.5	40.8	55.7	15,372
Occupation					
Professional	24.3	22.1	53.6	45.9	14,540
Business Executive	9.3	7.4	83.3	65.3	41,824
Clerical	53.0	19.7	27.2	31.9	3,972
Sales	36.4	9.1	54.4	32.4	5,959
Skilled Labour	39.4	3.9	56.7	27.7	3,407
Unskilled Labour	72.0	10.1	17.8	17.1	1,261
Retired	29.6	23.6	46.6	59.0	14,088
Other	33.6	23.8	42.6	41.3	6,819
Average per Household ..... %	23.1	12.2	64.8	45.8	9,339
" " ..... $	2,156	1,139	6,044		

TABLE 2–9

DISTRIBUTION OF LIQUID AND OTHER CASH PRODUCING ASSETS OF HOUSEHOLDS, BY TYPE OF ASSET, AND BY LEVEL OF INCOME AND TOTAL ASSETS, SEVEN METROPOLITAN AREAS[a], LATE 1962

(Per Cent)

—	Deposits	Canada Savings Bonds	Other Bonds	Mortgages and Other Loans	Shares		Equity in Own Business	Real Estate	Total $
					Publicly Traded	Investment Groups[b]			
1961 Income–$									
Under– 3,000	62.3	5.7	1.5	13.6	1.5	8.2	6.8	0.5	1,153
3,000– 4,999	35.5	5.9	7.3	6.0	4.0	1.7	29.0	10.5	3,049
5,000– 6,999	24.7	9.8	3.8	10.4	11.5	2.0	11.7	26.1	5,136
7,000– 9,999	18.5	9.1	3.7	2.4	14.0	1.0	28.3	23.0	10,701
10,000–14,999	12.6	6.9	3.9	3.7	7.4	0.9	34.5	30.2	20,976
15,000 and Over	5.0	4.2	5.8	7.6	12.2	1.3	58.8	5.1	108,360
Total Assets–$									
0– 999	86.5	10.4	1.3	0.5	0.1	1.1	—	—	270
1,000– 4,499	66.4	16.1	0.7	3.7	4.4	0.7	6.2	1.9	1,446
4,500– 7,499	54.3	6.7	0.4	10.4	10.3	2.0	15.4	0.7	4,074
7,500– 9,999	27.8	25.8	3.6	5.0	7.1	10.2	2.8	17.7	3,445
10,000–14,999	44.8	12.1	0.4	8.9	7.4	3.5	9.0	14.0	2,150
15,000–24,999	50.4	8.6	3.2	3.6	6.3	4.1	5.8	17.9	2,528
25,000–49,999	27.0	14.2	9.3	8.6	8.1	2.8	11.3	18.6	10,204
50,000–99,999	13.7	9.1	3.8	6.7	12.4	2.3	27.3	24.7	40,126
100,000 and Over	2.9	4.9	6.2	6.3	11.5	0.5	53.4	14.4	184,227
Average per Household %	15.3	7.8	5.7	6.5	10.4	1.6	36.4	16.4	100.0
" " " $	1,425	731	531	608	974	146	3,397	1,527	9,339

[a]For list of Metropolitan areas see Table 2–1, fn. [a].

[b]Investment mutuals, trusts and clubs.

with financial matters, generally are less likely than others to do so. By contrast, the absolute amounts held rise with income and age; this is true also if savings bond holders are classified by total assets—the only drop in holdings occurring in the $10,000 to $25,000 range, in which—as already noted—there is a much larger proportion of all assets invested in home ownership and in which financial assets are a relatively small proportion of the total.

The ratio of all liquid assets to total financial assets falls in the higher income, asset and age brackets because of the tendency to invest surplus funds in riskier categories—the only exception being the two oldest age categories in which higher liquid asset ratios are held, presumably in anticipation of emergencies and death duties. The principal exception to the generalization that the share of deposits within the liquid asset total falls with income and wealth is found in households with assets in the $10,000 to $25,000 range; it is presumably due to the low total of financial assets held in these categories, since the absolute amount of deposits is above that in the next lowest category and substantially below that in the grouping immediately above.

Non-liquid holdings of debt appear to be a surprisingly low percentage of household assets, although both their absolute amounts and their share in the total tend to be roughly correlated with income, age and total assets. Once again, however, there is an exception in the middle asset ranges. In the lowest income group, mortgages account for the highest proportion of these debt holdings, and appear to arise from the sale of owned homes. The absolute amounts involved are, however, larger in higher-income and asset categories where a large denomination mortgage is not difficult to hold on a portfolio basis. Smaller and older families also hold relatively

TABLE 2–10

DISTRIBUTION OF LIQUID AND OTHER CASH PRODUCING ASSETS OF HOUSEHOLDS, BY TYPE OF ASSET, AND BY AGE AND OCCUPATION OF HEAD OF HOUSEHOLD, SEVEN METROPOLITAN AREAS, LATE 1962

(Per Cent)

—	Deposits	Canada Savings Bonds	Other Bonds	Mortgages and Other Loans	Shares		Equity in Own Business	Real Estate	Total $
					Publicly Traded	Investment Groups[a]			
Age of Head–Years									
29 and under	26.0	4.6	2.5	4.3	6.0	1.4	51.1	4.1	2,403
30 to 39	17.2	6.0	1.0	3.7	7.7	1.5	50.3	12.6	5,199
40 to 49	13.8	4.5	1.4	4.3	6.1	1.5	46.9	21.5	9,206
50 to 64	12.8	9.2	6.1	7.6	10.9	1.2	34.3	18.0	15,978
65 and over	19.9	11.9	16.9	10.6	20.0	2.9	7.2	10.7	15,372
Occupation									
Professional	11.4	12.9	6.5	15.6	14.4	4.2	29.4	5.6	14,540
Business Executive	6.2	3.1	3.9	3.5	5.5	0.8	62.7	14.3	41,824
Clerical	34.5	18.5	1.3	18.4	8.6	2.6	4.1	11.9	3,972
Sales	27.3	9.1	7.6	1.5	12.7	1.6	7.6	32.5	5,959
Skilled Labour	32.1	7.3	0.2	3.7	3.7	1.1	17.6	34.3	3,407
Unskilled Labour	64.9	7.1	—	10.1	4.8	0.4	—	12.6	1,261
Retired	19.5	10.1	14.6	9.0	28.7	0.8	—	17.1	14,088
Other	14.0	19.6	20.6	3.2	29.5	3.0	—	10.1	6,819
Average per Household %	15.3	7.8	5.7	6.5	10.4	1.6	36.4	16.4	100.0
" " " $	1,425	731	531	608	974	146	3,397	1,527	9,339

[a]Investment mutuals, trusts and clubs.

large proportions of mortgage investments since they have an incentive to move into smaller accommodation and frequently make vendor loans to sell their properties. Being older, they have also had time to accumulate more assets and pay off debt, and security of investment income becomes important; these factors make both mortgages and other bonds more attractive to them than alternative outlets. Members of the professions also invest relatively heavily in mortgages, partly in vendor form, but also apparently for portfolio purposes because of the special skills of lawyers and architects.

Investment in marketable equities is again positively related to income, age and assets, and tends to be most pronounced in the top group of each category, partly because of their increased risk-bearing capacity and partly because the dividend tax-credit is most important to the upper income groups. The average holding of equities in the lowest income group is only about $112, and it is interesting to note that $95 of this is held through investment clubs or mutual funds; this serves to indicate the role that such institutions can play in attracting the small investor in equity markets. Indeed, about 15% of all investment in publicly-traded equities takes this form.

Equity in real estate follows a similar pattern, although its importance drops off in the highest age, income and asset categories. Older people are apparently less willing to incur the difficulties of managing property. Moreover, the survey indicates that the highest income and wealth categories—which include business executives and the professions—have a very large proportion of their assets invested in their own businesses. The relative importance of investment in one's own business declines in relative size—but not absolute amount—with the age of the householder until age 65; it then falls sharply in amount as the business is sold or passed on to the next generation. The size of the average house-

hold's investment in a family or private business, at $3,397, seems high in relation to other investments and we have no way of knowing whether it is representative or not; in any event, 5.9% of households had such investments, indicating a total of over $58,000 per household concerned. A few larger businesses owned by the high asset groups were responsible for this high average.

As Table 2-11 shows, holdings of liquid and other cash-producing investments are concentrated in varying degrees. Liquid assets are most widely distributed, with only 10% of households having no deposits with financial institutions. However, as can be seen from the table, only 30% of households held Canada Savings Bonds, only 12% held publicly-traded shares, and just 5% to 8% of the sample held any of the other assets dealt with in this section. Most of this minority of households held only moderate amounts of the various assets concerned. However, except for deposits and shares in investment funds and investment clubs, holdings of $10,000 and over accounted for more than one-half the value of each type of investment held. It is particularly interesting to note that 56% of outstanding Canada Savings Bonds were owned by those with holdings in excess of $10,000; even if accumulated over a period of years, holdings of this size are well outside the category of small savings, and indicate that the market for C.S.B.'s is in direct

TABLE 2–11

DISTRIBUTION OF NUMBER AND VALUE OF HOLDINGS OF LIQUID AND OTHER CASH INCOME PRODUCING ASSETS BY TYPE OF ASSET AND SIZE OF HOLDING, SEVEN METROPOLITAN AREAS,[a] LATE 1962

(Per Cent)

Size of Holdings $	Deposits	Canada Savings Bonds	Other Bonds	Mortgages and Other Loans[b]	Shares		Equity In Own Business	Real Estate	Total[d]
					Publicly Traded	Investment Groups[c]			
	Number of Households								
0	9.7	70.2	94.9	94.2	87.7	93.5	94.1	91.7	8.0
1– 999	57.3	18.4	1.6	0.9	5.2	3.4	0.3	0.6	43.4
1,000– 4,999	26.5	8.1	1.7	2.3	3.8	2.3	1.4	2.2	26.7
5,000– 9,999	4.2	1.7	0.6	1.2	1.4	0.5	0.9	1.3	8.3
10,000–24,999	2.0	1.3	0.6	1.0	0.9	0.2	0.8	2.4	6.8
25,000–49,999	0.2	0.2	0.4	0.1	0.6	0.1	0.8	1.0	2.7
50,000 and over	0.1	0.1	0.2	0.2	0.4	—	1.8	0.8	4.1
TOTAL	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
	Total Value of Holdings								
0	—	—	—	—	—	—	—	—	—
1– 999	13.8	8.7	0.8	0.7	2.2	7.3	—	0.2	1.6
1,000– 4,999	40.0	21.4	6.8	10.3	8.9	33.2	1.0	2.9	6.7
5,000– 9,999	18.8	14.3	6.6	12.5	11.2	18.4	1.5	6.0	6.2
10,000–24,999	19.0	24.0	17.7	23.6	15.1	16.7	3.2	23.8	11.2
25,000–49,999	4.0	7.7	21.5	6.7	21.7	24.4	7.3	19.8	9.9
50,000 and over	4.4	23.9	46.6	46.2	40.9	—	87.0	47.3	64.5
TOTAL	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

[a]For list of metropolitan areas see Table 2–1, fn. [a].
[b]Excludes balances with brokers.
[c]Investment funds, trusts and clubs.
[d]Includes balances with brokers.
SOURCE: See Table 2–1

competition with that for marketable government securities. The other assets are held in even more concentrated amounts, with holdings of over $10,000 accounting for 97.5% of equity in owned businesses (a figure which is not entirely surprising in view of the amount of equity needed in even quite small firms other than in the retail or service industries), 91% of income-producing real estate, 86% of other bonds, 78% of publicly-traded shares, and 77% of mortgages and other loans.

FINANCIAL INVESTMENT AND LOCALITY

While it proved impossible for us to conduct our survey outside the main metropolitan regions, other information suggests that the relative attractiveness of the different types of financial and other cash-producing investments varies from place to place. This presumably reflects differences in knowledge and in investment opportunities. Information about publicly-traded securities, for example, is more accessible in communities large enough for security dealers or trust companies to maintain branches, while competition for investible funds—in terms of information and other services—is more intense in larger communities. In small centres the banks are often the only institutions to maintain branches, and they are not equipped to offer a full investment service. Similarly, because they cannot make loans on existing property nor invest in rental real estate, and because other financial institutions are not active in small localities, the opportunity for individuals in such localities to make real estate and mortgage investments is increased.

Table 2-12 gives an indication, by size of centre, of the pattern of investment in certain types of assets which produce taxable investment income. Unfortunately, the data do not permit us to draw a distinction between smaller communities which were relatively remote and those which were close to larger centres. Moreover, there is no way to separate the influence of geography from those of income and assets, which rise with size of locality.

As can be seen, the share of dividends in investment income declared for tax purposes increases with the size of centre, being 38% of investment income and 2½% of total income in the largest communities compared to 28% and 1% respectively in the smallest localities. By contrast, the proportion of mortgage, bond and bank interest in investment income declines with increases in

TABLE 2–12

PERCENTAGE DISTRIBUTION OF INVESTMENT INCOME BY SOURCE, DECLARED FOR TAXATION BY TAXABLE INDIVIDUALS, BY SIZE OF CENTRE, 1960

Size of Centre (Number of Taxable Returns)	Average Total Income $000	Investment Income — % of Total Income	Investment Income						
			Dividends	Rentals	Bond and Bank Interest	Mortgage Interest	Annuities	Estates	Total
Under 4,000[a]	4.0	3.6	28.0	15.0	33.2	14.5	1.1	8.2	100.0
4,000 to 9,999	4.1	3.7	29.7	17.7	29.2	12.3	1.2	9.9	100.0
10,000 to 24,999	4.1	4.0	31.5	17.1	29.0	10.6	1.2	10.6	100.0
25,000 to 124,999	4.3	5.0	32.2	16.6	26.5	10.0	1.4	13.3	100.0
125,000 to 629,736	4.4	6.5	37.7	14.3	22.5	10.1	1.3	14.1	100.0
CANADA[b]	4.2	5.0	33.9	15.2	26.2	11.1	1.3	12.3	100.0

[a]Includes "other areas".
[b]Includes non-residents.
SOURCE: Department of National Revenue, *Taxation Statistics. 1962.*

the size of centre, reflecting the comparatively favourable opportunities for these forms of investment, and the relative difficulty of buying other types of financial assets, in smaller towns.

HOUSEHOLDS AS SUPPLIERS OF RISK CAPITAL

We have noted that 65% of the reported liquid and other cash-producing assets of households is invested in equities, income-producing real-estate and private or family businesses. This gives a rough measure of the amount of "risk capital" supplied by households, although it could be argued that some of the other debt instruments held should be classified as risk capital and that some of the shares and real-estate owned are in comparatively low-risk categories. If risk capital assets, as defined, are related to total assets, their proportion falls to about 30% because of the importance of home ownership in the aggregate figures. The percentage of all assets held in the form of publicly-traded equities alone is reported by those surveyed at just under 6%.

As part of the explanation of the large inflows of capital from abroad, it is often asserted that Canadians are innately conservative investors. To make an objective judgment on this question is very difficult: if the allegation is true, Canadians should either save more of their incomes and invest the marginal savings in risk assets or they should curtail their investments in home ownership, bank deposits and other liquid assets, debt securities and life insurance and pension funds. Even if they did so, there would not necessarily be an equivalent increase in flows of risk capital: for example, pension funds are increasingly important holders of equities, while bank lending can sometimes be a close substitute for risk capital investment. In any event, we are not prepared to state that Canadian personal savings are "too low"—either judged in isolation or in comparison to other countries. Nor can we prescribe that Canadians should redirect the flow of their savings. We shall return later to the question of non-resident capital flows and to the patterns of investment of Canadian financial institutions.

There are some data which nevertheless enable us to confirm that both the frequency and average amount of share ownership is less in Canada than in the United States. Our survey indicates that 12% of Canadian households in metropolitan centres hold shares (the figure is probably somewhat lower in the country as a whole). In contrast, a recent survey by the New York Stock Exchange[17] showed that 16% of adult individuals in that country—and presumably a larger proportion of households—held shares; the average holding was over $2,000 compared to the $1,120 reported in our survey.[18] This presumably, is as much a reflection of the higher incomes and wealth in the United States as it is of differences in investor attitudes.

Table 2-13, which is based on earlier data, compares the distribution of income and the incidence of ownership of publicly-traded shares in both Canada and the United States. Subject to limitations in the comparability of the data, it is apparent that ownership in publicly-traded shares in each income class is about the same in the two countries. What is significantly different is the proportion of households and income within each class; since a higher percentage of American households is in the higher income brackets where the largest share ownership is found, the total incidence of share ownership is greater in that country. Some of the difference in share ownership may also stem from the less rigorous disclosure requirements in Canada which require less informed risk-taking by Canadian investors. There is also a wider choice of investments open to the U.S. investor. Finally, leading American companies are usually larger and more diversified than leading Canadian companies, and the risks of investing in their shares may be correspondingly reduced. On the other hand, the Canadian equity investor received more favourable tax treatment—a larger tax credit for dividend income and no capital gains tax.

If it is desired to increase Canadian investment in equities, the problem must be tackled on a broad front. Basic investor attitudes and preferences are related to their basic risk-taking abilities

[17] *1962 Census of Share-Owners in America.*

[18] Including holdings through investment funds or clubs to make the figures comparable.

TABLE 2–13

INCIDENCE OF OWNERSHIP OF PUBLICLY TRADED SHARES, AND DISTRIBUTION OF INCOME BEFORE TAXES, FAMILIES AND UNATTACHED INDIVIDUALS, BY INCOME LEVEL, CANADA AND U.S., 1958 AND 1960.

Income Group $	Per Cent Holding Publicly Traded Shares		Per Cent of Total Income Received in 1958	
	Canada, Non-Farm 1959	U.S. 1960	Canada	U.S.
Under 3,000	4	5	13	9
3,000—4,999	5	7	27	16
5,000—6,999	13	13[a]	42	37
7,000—9,999	21	23[b]		
10,000 and over	44	43	18	28
All	9	14	100	100
Average Income—$	—	—	4,544	5,580

[a]Income range is $5,000—7,499.

[b]Income range is $7,500—9,999.

SOURCE: W. R. Waters, *The Investment Practices of Canadian Individuals* (M.B.A. Dissertation, School of Business, University of Toronto, 1962, unpublished) pp. 109 and 129, adapted. Original sources of data: D.B.S., *Incomes, Liquid Assets and Indebtedness of Non-farm Families in Canada. 1958;* the University of Michigan, Survey Research Center, *1960 Survey of Consumer Finances* (Ann Arbor: Braun-Brumfield, Inc., 1961).

and to their spending and other needs, and are not changed merely by exhortation. While much depends on the growth of incomes and wealth, measures must be taken to improve disclosure and security regulation standards and to encourage more corporations to treat their shareholders as genuine partners in the enterprise; tax incentives may also have an important part to play. At the same time, it is unreasonable to expect the small investor, who is ill-equipped to take the risks and spend the time involved in managing a very modest equity portfolio, to become a sizable direct source of risk capital. Thus, a balanced approach to the problem must also deal with the restrictions governing some of the institutions which indirectly invest his funds for him.

CONCLUSION

Our studies indicate that by and large Canadians manage their finances with greater wisdom than appears to be popularly believed. Most households appear to have a reasonable pattern of assets in relation to their family needs, income and risk-taking ability. Most, too, have made sensible use of instalment and other credit to acquire physical assets that yield them high returns, not only in financial terms but in terms of convenience and ease of household living. As we indicate later there are some areas where a more active policy of providing individuals with information and incentives to improve their financial decisions would be useful. In general, however, we have found that the financial system has provided an increasing range of services to savers. We have also found that services to individuals as instalment borrowers have been extended and improved, but comments made by respondents to our survey, and other evidence, suggest that facilities in the mortgage market have not always been adequate for their needs. Further discussions of the extent to which the financial system could improve the services offered to individual borrowers and savers will be found in the chapters dealing with the main institutions and markets.

CHAPTER 3

BUSINESS FINANCE

The business sector accounts for a very large proportion of our national production, employment and investment. It is also the major developer of the new and improved goods and services and productive techniques on which economic expansion and rising living standards are largely dependent. While it is thus particularly important to ensure that the financial system meets the legitimate needs of Canadian business enterprises, it is worth noting that a major share of their financing comes from their own retained profits and depreciation and depletion allowances. Even in 1956-57 when the investment boom was at its height, businesses raised over half of their gross financial requirements from internal sources.[1]

Since 1956-57 there has been a dramatic reduction in the business sector's demand for outside funds. In those two years, over 60% of the recorded increase of about $7.5 billion in all primary debt and equities outstanding was accounted for by business. This ratio has now fallen to about 20%, despite the fact that business investment still accounts for well over 50% of national investment. This reflects the further growth of internal funds—which now provide over two-thirds of gross business financing[2]—weaker demand conditions and lower levels of investment, and the emergence of governments as the main capital market borrowers. Indeed, an increasing number of individual business enterprises have actually become suppliers of funds to other economic units. We will examine these recent trends briefly to ascertain whether the financial system is adequately serving the sector's needs and then will turn to look at the special problems of small business and agriculture.

Our broad conclusion is that the financial system has provided the outside financing needed by most non-financial corporations on satisfactory terms and without unfairly discriminating between one borrower and another. This conclusion is based on the briefs and testimony of witnesses, on our staff studies, and on observation of the impressive increases which have taken place in business assets in the post-war period. Indeed, some have argued that the wide variety of new domestic and foreign sources of financing which have opened up to business borrowers, particularly after 1954, played a part in encouraging an over-expansion of business investment in 1955-57 which later proved only marginally profitable. This led to disappointing gains in output per worker over the economy as a whole, and having contributed to inflationary pressures in the late 1950's, was a factor in the subsequent weakness in Canadian demand and employment. However, this over-expansion appears to have stemmed mainly from intense world demand for Canadian products which also led to heavy foreign direct investment in Canada, from the over-confidence of businessmen, and from unduly easy monetary and fiscal policies in 1954-57.

[1] Business investment outlays reached a peak rate of over $6.5 billion annually at that time, about 50% higher than the rate in early 1955.

[2] Housing investment and depreciation, which is included in the business sector of the National Accounts, is excluded from this calculation.

There is no doubt nonetheless that there has been a desirable increase in the willingness of the principal Canadian lenders to take risks and become more competitive. While there has also been evidence of a decline in credit standards in some directions, we do not believe that undue amounts of credit are being extended to the business sector generally. Debt and interest coverage ratios are naturally somewhat less satisfactory than in the special conditions prevailing at the end of the war, but they are by no means dangerous; similarly, for example, bank losses on loans have risen, but in 1962 were under ½ of 1%.

THE DEMAND FOR FUNDS

The sizable growth in the need for funds by non-financial corporations in the post-war period is shown clearly by the expansion of their assets. By 1960—the latest date for which we have comprehensive figures—these assets had grown by no less than 270% from their 1946 level, or 10.5% a year, compared to a growth of only 150% in the United States.[3] While the number of companies has also grown, the percentage increase in the assets of 69 large firms and their affiliates specially surveyed for us was virtually the same as for all companies.[4] The need for capital to finance this relatively rapid increase in Canadian business assets, amounting in total to $47 billion for the 15 year period, helps to explain why our interest rates have been higher than those in the United States and why the flow

[3] Figures are book values before depreciation and based on taxation statistics.

[4] See the appendix volume for the annual balance sheets and operating results of these companies.

TABLE 3–1

SELECTED BALANCE SHEET ITEMS FOR ALL NON-FINANCIAL CORPORATIONS, 1947 AND 1960
(millions of dollars)

	1947	1960	Absolute Increase	Per Cent Increase
Assets:				
Cash	$ 884	$ 1,680	$ 796	90.0
Marketable securities	1,499	2,994	1,495	99.7
Accounts Receivable	1,598	6,015	4,415	276.4
Inventories	2,937	8,940	6,003	204.3
Buildings and equipment	8,723	32,245	23,522	269.6
Investment in affiliates	1,428	5,890	4,462	312.4
Miscellaneous assets	2,175	6,489	4,314	198.3
Total Assets	19,244	64,253	45,009	233.8
Liabilities:				
Bank loans	690	2,901	2,211	320.4
Accounts payable	1,557	3,937	2,380	152.8
Funded debt	2,092	7,443	5,351	255.7
Other liabilities	979	7,256	6,277	641.1
Capital Stock	5,206	11,104	5,898	113.2
Surplus	3,736	14,371	10,635	284.6
Depreciation reserve	4,284	14,598	10,314	240.7
Miscellaneous liabilities	700	2,643	1,943	277.6
Total Capital and Liabilities	19,244	64,253	45,009	233.8
Sales	18,048	57,427	39,379	218.1
Number of Companies	28,087	77,755	49,668	176.8

NOTE: Total assets in 1946 were $17,270 million, but the detail shown above is only available from 1947 onwards.
SOURCE: *Taxation Statistics.*

of foreign capital into this country has been heavy.

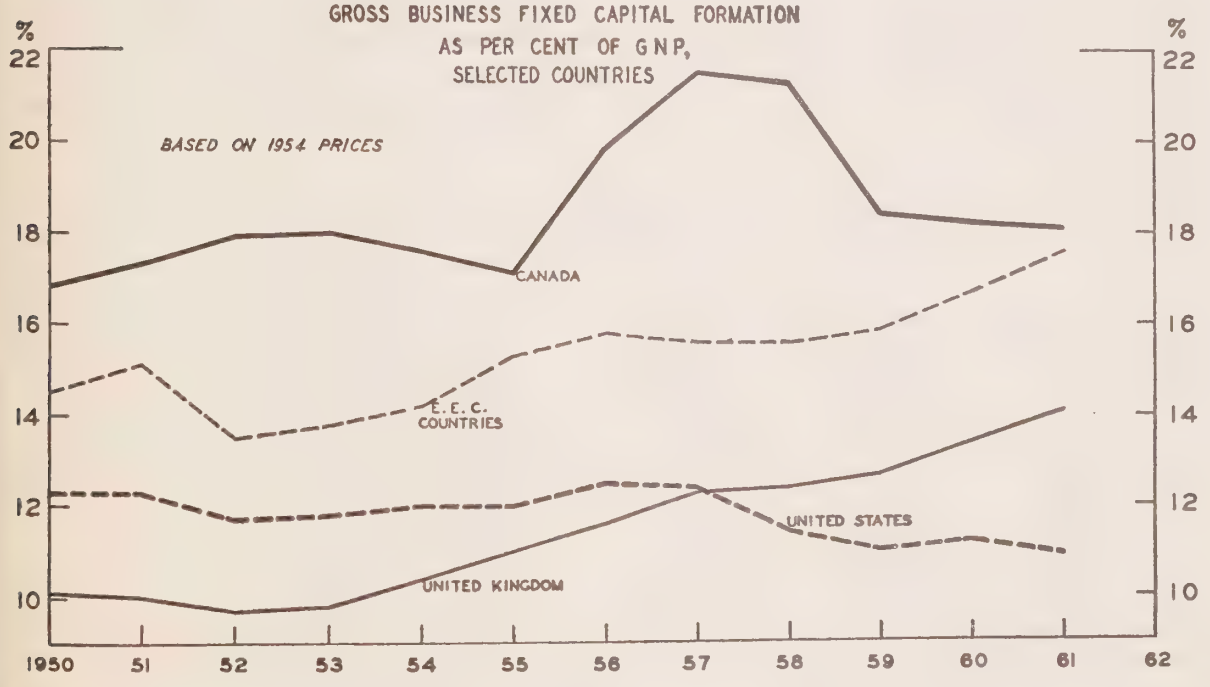
By far the largest part of these increases has been for buildings and equipment with which to expand and modernize Canadian industry and develop new resources such as Quebec-Labrador iron ore, Western oil and gas, and major power projects in all parts of the country. As Table 3-1 shows, investment in affiliates has also grown at rapid rates, reflecting the trend to larger and more diversified corporate activity. Accounts receivable, the trade credit extended to other businesses and individuals, have shown substantial increases too, particularly in recent years when highly competitive conditions have forced corporations to extend more favourable terms to their customers to attract and retain business.

On the other hand, inventories have risen less than proportionately, a tendency that has become more pronounced as fears of rising prices have receded, better methods of inventory control have been developed, and supplies have become more quickly and easily available. Corporate assets in the form of cash and other liquid assets such as marketable securities have also risen relatively slowly, reflecting the running down of high corporate liquidity at the end of the war as well as better budgeting methods. There has also been a growing willingness to operate with lower liquidity rates in view of the ability to raise needed cash quickly under authorized lines of credit from the banks or from borrowings in the bond and money markets. Cash holdings have fallen with particular sharpness because of the development of profitable new sources of short-term investment in the financial institutions and markets. On the other hand, marketable securities other than those of the Government of Canada have increased both absolutely and as a percentage of sales in the post-war period.

Canadian business investment reached a peak in 1957 as buoyant expectations and strong domestic and world demand led to the expansion and development of a wide range of resource

Chart 3-1

GROSS BUSINESS FIXED CAPITAL FORMATION
AS PER CENT OF GNP,
SELECTED COUNTRIES



75319—4½

and manufacturing industries in all parts of the country. As Chart 3-1 shows, such investment accounted for about 22% of national production, a level much higher than that in other industrial countries[5] and only matched in Canada at the time of the railway boom in the early years of this century. Despite the sharp fall since 1957, business investment in Canada remains relatively high compared to levels elsewhere, a reflection of the nature of our economy with its capital-intensive resource and power projects and the heavy investment outlays needed to provide a small population with telephone, gas distribution and transportation facilities like the St. Lawrence Seaway. Moreover, more capital is needed to produce a given amount of output in Canada than in the United States because our domestic manufacturing is still too unspecialized to have long production runs which make the best use of its machinery; these machines are often less intensively utilized than in the United States owing to time lost changing over from one type of production to another.[6] Finally, Canadian depreciation allowances and, until the 1963 budget, the tax treatment on many building materials used in investment were favourable to fixed capital outlays; these factors undoubtedly contributed to relatively high levels of business investment in this country.

The major reason for the fall in business capital outlays in recent years has been the emergence of spare capacity as demand failed to expand at the optimistic rate expected and more intense domestic and international competition developed. This has been reflected in declining profit margins in relation to sales, assets and equity; in manufacturing, for example, the return on equity has fallen from nearly 15% in the buoyant conditions of 1951 to about 8% in 1963. The number of companies reporting losses to the taxation authorities has also risen from about 27% of the total in 1956 to close to 35% in the early 1960's, while failure rates have increased from under 60 per 10,000 to close to 80 and the liabilities involved have virtually doubled.

Despite the continuance of highly competitive conditions, some improvement in profitability has occurred in 1962 and 1963 as a result of strengthened demand, devaluation of the Canadian dollar and management efforts to cut cost ratios from the inflated levels they had reached in the easy

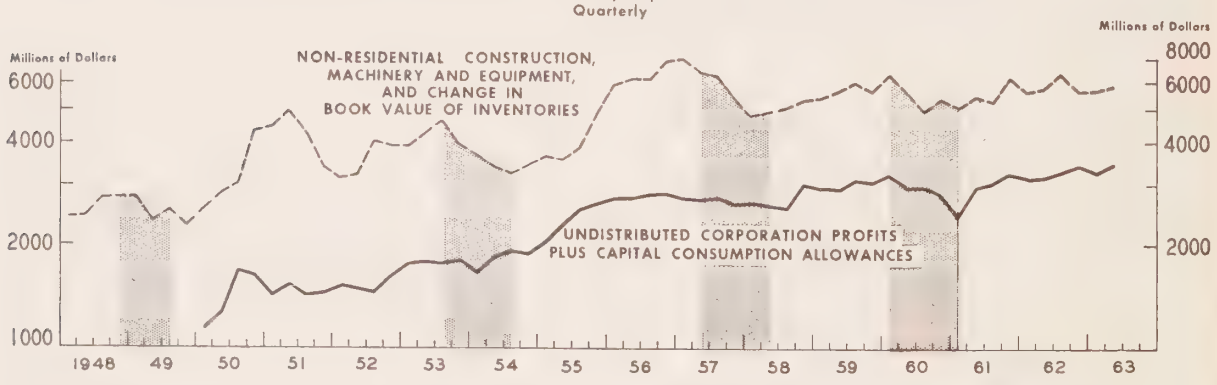
[5] Published figures are adjusted for comparability, and include outlays by government enterprises deriving their revenue primarily from the sale of goods and services to the public.

[6] A calculation based on output and taxation statistics indicates that capital-output ratios were 34% higher in Canadian than American manufacturing in 1960.

Chart 3-2

BUSINESS INVESTMENT AND CORPORATE INTERNAL FUNDS,[1] 1948-1963

Seasonally Adjusted
Quarterly



1. Business investment as shown in the upper line of the chart includes that by unincorporated enterprises and non-governmental institutions: the amounts involved are probably of the order of $1 billion in 1962. The extent of corporate internal financing is therefore understated.

Recession phases of Canadian cycles are shaded.

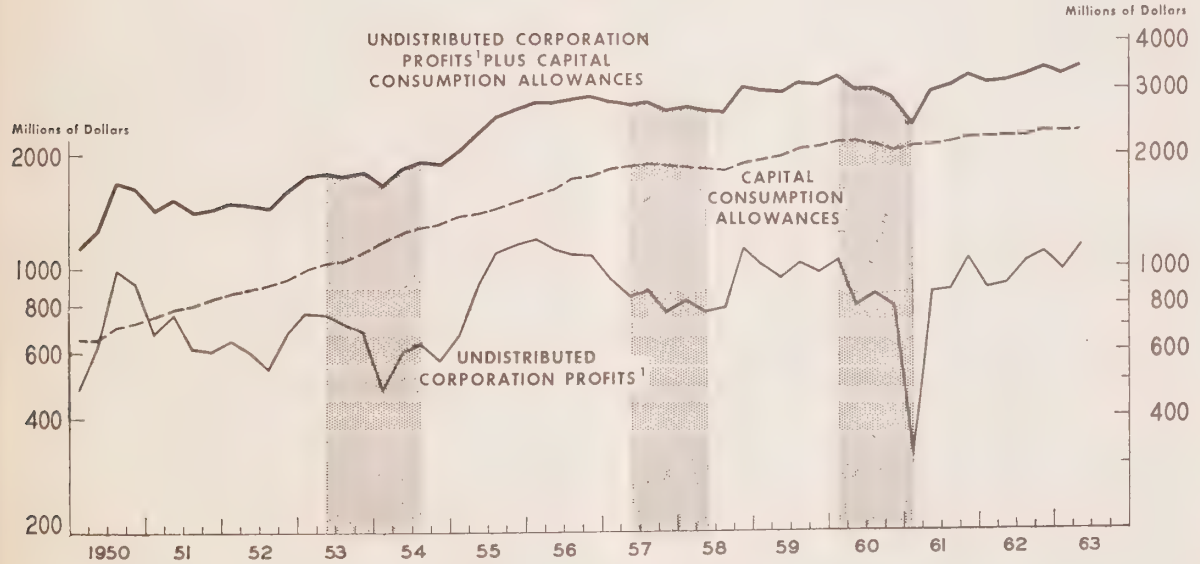
times preceding 1958. Nevertheless, corporate profits after taxes increased by only 26% from 1955 to early 1963, equivalent to a marginal rate of under 5% on the increase of about $9.5 billion in total corporate equity in the same period.[7] In fact then, much of the substantial investment in this period turned out to be temporarily unprofitable or was "defensive" in nature, i.e. made to modernize or cut costs to prevent profit rates from falling still further.

As business groups told us, the prospect of profits is the main motive for investment, and it is not surprising therefore that the existence of unused capacity and its attendant reduced profit margins have caused investment to fall even though internal funds in the form of undistributed profits and capital consumption allowances have risen. In mid-1963, these were more than 25% above their 1957 level, equivalent to 70% of business physical investment compared to 51% seven years earlier when investment was being induced by shortages of capacity and high prospective profits.

There has continued to be considerable short-run volatility in business investment in buildings, equipment and inventories, which has declined in each of our post-war recessions (indicated by the shaded areas in Chart 3-2). Indeed, these declines—which have ranged between $1.0 and $1.6 billion at annual rates in the last three business cycle contractions—and subsequent expansions have been a significant contributor to the variations which have occurred in national output. These variations in turn have had a pronounced short-run impact on corporate profits, although—as Chart 3-3 indicates—the effect on total internal funds has been modified in reces-

[7] If 1956—the peak profit year of the 1955-57 boom—is taken as the basis for this comparison, the marginal return is about halved. However, 1955 seemed a better base period as it represented a very good—but not abnormal—profit year.

Chart 3-3
CORPORATE INTERNAL SOURCES OF FUNDS
1950-1963
Seasonally Adjusted
Quarterly



1. The unusual pattern of undistributed corporate profits in late 1960 and early 1961 reflected high payments by non-resident controlled companies associated with the impending imposition of higher withholding taxes.

Recession phases of Canadian cycles are shaded.

sions by the greater stability and long-run upward trend of capital consumption allowances.

SOURCES OF FINANCE

As Table 3-1 shows, depreciation reserves and the growth of surplus have been the largest source of financing for business expansion in the post-war period, accounting for almost half the total. In recent years, capital cost allowances alone have provided over $2 billion annually compared to an average of about $300 million from bank loans and under $400 million from bond and stock issues combined. Undistributed profits have grown more slowly because of the narrower margins already referred to. Moreover, dividend pay-outs have risen from their abnormally low level of 40% of earnings in 1956 to a record post-war level of 55% in 1961. Nevertheless, retained profits have since late 1962 provided over $1 billion annually, or more than the security markets and banks combined.

Since the capital cost allowances claimed for tax purposes under the Canadian tax system need not correspond to the amount of depreciation charged in the corporate books of account, the figures based on taxation statistics tend to deflate retained earnings relative to depreciation, but the two taken together reflect correctly the extent of the funds generated internally. The higher the rates of capital cost allowances permitted the greater is the temporary tax saving available to the corporate tax payer. Liberal capital cost allowance provisions, by deferring current tax liabilities, therefore reduce the need to rely on outside financing. Some countries, such as Sweden, have at times used this device as an incentive to corporate investment. Canadian capital cost allowance provisions in recent years have on average been higher than those in the United States, but the effects of such provisions on investment decisions in Canada appear from our staff work and other studies to have been small.

We have already noted that business enterprises have obtained a sizable amount of funds from within the corporate sector, either from affiliated or parent companies in Canada or elsewhere (reflected in accounts payable and "other liabilities" in Table 3-1) or in trade credit from suppliers. These two sources accounted for a further 20% of the funds expended by corporations in the post-war period, or about four times as much as bank loans. Indeed, long-term corporate debt held by related companies is now very large in relation to the total outstanding. Short-term trade credit received by corporate business has grown by less than credit extended, indicating a net extension to consumers, unincorporated business, governments and the foreign sector. At the same time, our corporate survey found examples of small firms relying on larger ones for their financing and indicated that such credit is relatively more important to them, particularly in periods of tight credit conditions.[8] This can be an expensive source of financing to smaller firms with no alternative sources of finance since an invoice due in 30 days with a 2% discount for payment within ten days is in effect charging an annual interest rate of more than 36%. However, competition has led to the reduction and gradual disappearance of such discounts, to increasingly long payment terms and to the "taking" rather than granting of trade credit.

USE OF THE CAPITAL MARKET AND BANKS

Because of the growing importance of internal and inter-corporate financing, the capital markets —and in particular the banks—have played a declining role in the financing of businesses, especially the larger enterprises. Many firms are still largely dependent on bank financing, but the increase of $2.2 billion in bank loans to business from 1947 to 1960 represented only 5% of the increase in total funds employed, a small share by pre-war standards and equivalent to less than 25% of the increase in inventories and accounts receivable, the traditional assets against which banks lend. This reflects the development of competing sources of short-term lending—particularly the opening up of the money market in which many businesses with surplus short-term funds

[8] However, large firms remain the major users of trade credit in dollar amounts.

invest—the increasing needs of many enterprises for longer-term funds than the banks have been able or willing to supply, and the restraints on bank lending in periods of high credit demand.

Securities issues in the stock and bond markets have been a more important source of financing than bank loans, although the share of total funds raised in this way is smaller than before the war. The moderate growth in securities issues has resulted in part from the growing importance of mortgage financing and from the emergence of the instalment finance companies as a significant source of funds for some businesses; moreover, leasing of buildings and equipment, particularly cars and trucks, has also become quite widespread in recent years. Under "lease-backs", widely used in shopping centre and building financing, the tenant agrees to pay the owner a specified rental for an agreed period and often has the subsequent option to purchase.[9] In effect, long-term debt has been incurred although no securities have been issued and no liability shows on the borrower's balance sheet.

At their peak in 1956 and 1957, net funds raised from bond issues by non-financial corporate business averaged over $700 million annually while an additional $400 million was raised in each of the two years by stock issues. Even at this level, the combined sums raised were not much over one-third of the amounts generated internally; in 1960-62 they fell to not much over 10% of capital cost allowances and retained profits. From 1946 to 1958, the amount raised from bond issues was about double that from equities, although in recent years they have been about equal in importance as some companies have needed to rebuild their equity to debt ratios or have been unwilling to incur relatively heavy debt charges. Moreover, some issuers which have continued to make heavy outlays—like the utilities—are not able to raise a high proportion of their requirements internally, because of the large amounts of new capital they require; they typically obtain large amounts in equity markets to keep a balanced capital structure.[10] Other firms with continued heavy capital outlays or with more risky projects have also found equities the most appropriate way to raise external finance. Finally, equities have assumed more importance within the diminished total of security issues because stock yields have declined as the public has increased its purchases of equities to hedge against inflation or to share in the country's growth;[11] meanwhile, corporate bond yields have remained relatively high.

The relative yield costs of issuing bonds and stocks are shown on Chart 3-4. From the corporation's point of view, there is always an incentive to issue debt as long as the costs of doing so are less than the return which will accrue from the extra assets because the shareholder benefits from this additional "leverage" on this equity. Of course, the views of corporate management about assuming unduly heavy debt burden and maintaining a sound financial position put limits on this process, as do the views of banks and institutional and other investors. Given these basic conditions, however, the fact that interest charges are deductible as an expense before computing taxable profits and that dividends must be paid from income after taxes means that pre-tax operating earnings must be twice as high to pay out the same amount in dividends as in interest charges.[12] For this reason, preferred shares with their fixed dividend have become much less important than formerly and now account for only about one quarter of all stock issues. Instead, many corporations have preferred to issue junior-ranking debt convertible into equity or carrying warrants to subscribe to

[9] In shopping centres there is frequently a minimum rental and an "overage" related to the sales or profits of the tenants.

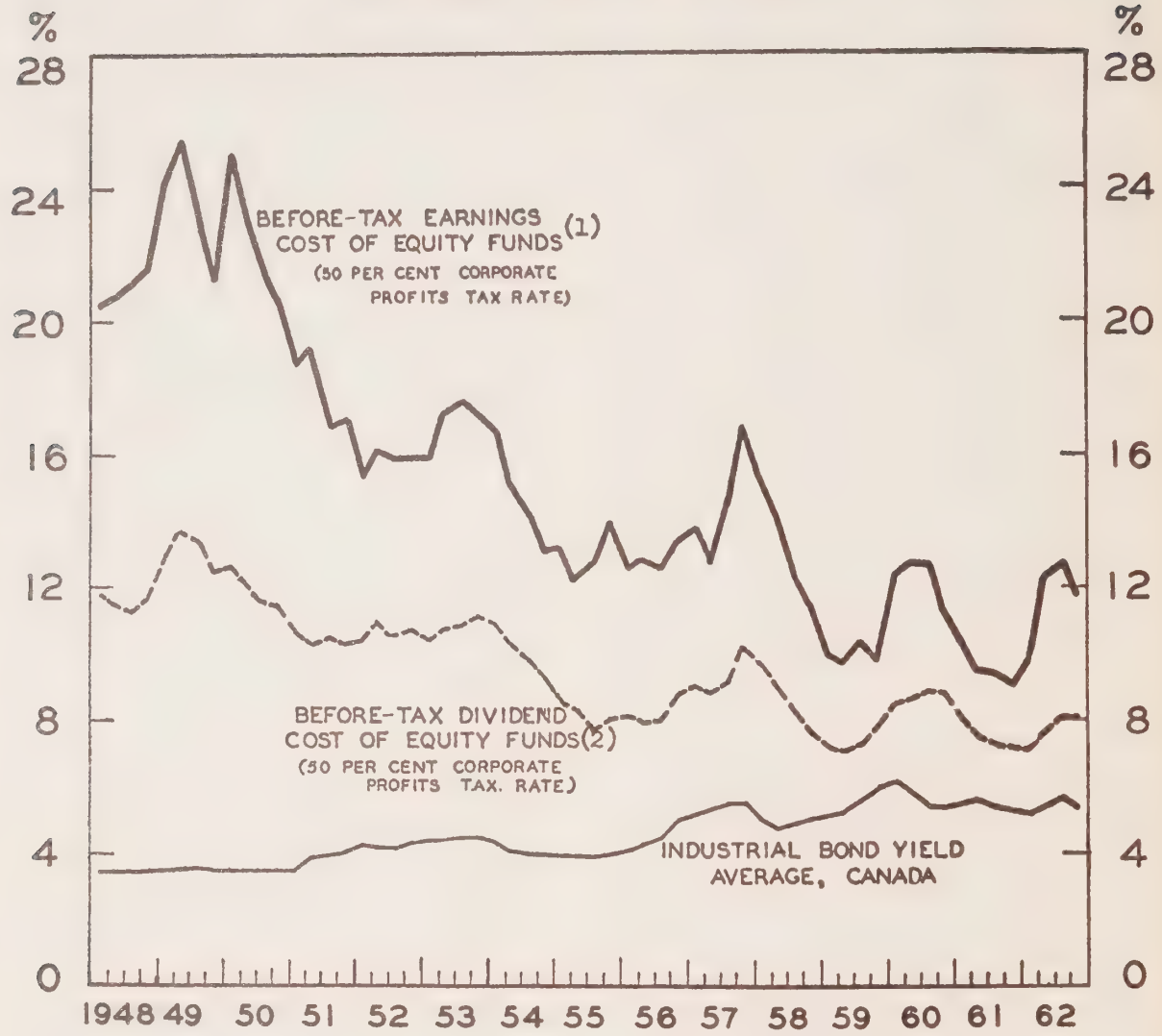
[10] Despite this factor, their debt ratios are normally higher than those in manufacturing because there is less volatility in the gross revenues of public utilities and it is thus appropriate for them to incur relatively larger debt charges.

[11] The 20% tax-credit on dividends has also played a part in this process.

[12] Assuming a 50% corporate tax rate, if $50 of additional interest is paid, operating earnings need rise only $50 for existing shareholders to be unaffected. If extra shares paying a dividend of $50 are sold, operating earnings must rise $100; this will be fully absorbed by extra tax liabilities of $50 and the dividends to new shareholders of an equivalent amount.

Chart 3-4

BEFORE-TAX COSTS OF FUNDS AND YIELDS ON CORPORATE BONDS AND STOCKS



(1) This is the price/pre-tax earnings ratio expressed as a percentage figure, i.e. if the stock is selling at $10 per share and earning $2 per share before taxes, the chart will show a before-tax earnings cost of equity funds of 20%. Based on Canadian Business Service Ltd. price/earnings data.

(2) The before-tax dividend cost to the issuer is double the yield to the purchaser on the assumption of a 50% corporate profits tax. Based on Moss, Lawson & Co. Ltd. dividend yield series.

the equity, often at increasing prices over a ten-year period.

The chart shows stock yields on a before-tax basis, and indicates that in 1948-50 the cost of equity funds to a representative corporation was of the order of 20% to 25% on the basis of earnings—i.e. stocks were typically selling at four to five times pre-tax earnings. Since dividend yields were 5½% to 6½% in this period, the pre-tax cost on the basis of dividend yields was 11% to 13%; meanwhile bond yield costs were only 4%. Even in late 1962, despite the change in stock and bond yields which had occurred in the meantime, the earnings and yield costs of stock issues were 12% and 8% respectively compared to about 5½% for bonds.

While these tax considerations are more important now than when corporate rates were lower, the general statistics do not indicate that they have induced unsound financing practices in the corporate sector. Equity to funded debt ratios for all the companies shown in Table 3-1 have of course declined from their abnormally high level of 4.3 to 1 in 1947 but appear to be quite reasonable at 3.4 to 1; moreover, since 1960 they have probably risen somewhat. The data for 69 large companies indeed shows some increase over the period as a whole, while data for 37 smaller companies shows no change. In fact, interest charges in corporate manufacturing have remained at the very low level of around ¾ of 1% of sales in the post-war period. Moreover, the bond and mortgage interest paid by all non-financial corporations in 1960 was covered about 11 times by pre-tax corporate profits; at $300 million, these payments were only a third of the amount paid out in dividends to Canadian individuals and all non-residents.

While the non-deductibility of dividends may limit the supply of equities at the margin, as does the attractiveness of issuing debt in periods of rising prices, we found no evidence that it had major distorting effects on the capital market or financial position of business. As we will point out later, other factors—including wide non-resident ownership, the small size of many Canadian companies, and government ownership of many utilities—have been more important in restricting the supply of equities available to the Canadian investing public.

Nor does the data reviewed above suggest that there has been a drastic general decline in the quality of credit extended. Loan to value ratios have risen in many instances as financial institutions have acquired additional experience or developed new lending techniques, while the term of many types of loans has been lengthened. It is always difficult to distinguish between sound and desirable increases in the willingness of lenders to extend credit for legitimate purposes and a general deterioration in the quality of credit, although we have the impression that there have been some excesses in the granting of business credit—particularly for speculative real-estate purposes.

The securities issued by Canadian corporations are sold to a wide variety of holders, some being placed directly with parent companies and domestic and non-resident institutions and others being offered for public subscription. The following table shows that pension funds and insurance companies have been particularly important purchasers of corporate bonds in recent years. Non-residents have continued to account for over a third of holdings compared to 56% of holdings before the war; in contrast, their ownership of corporate equities has risen sharply.

The timing of market and bank financing by business is naturally related to the business cycle pattern. While complete and current data on Canadian corporate assets and liabilities are not available (although D.B.S. is developing a quarterly series by industry which will fill this important gap), there is comprehensive information available in the United States where the pattern of corporate behaviour is very similar.[13] In the early stages of business recoveries, relatively high rates of internal saving and low levels of physical investment are reflected in large increases in liquid asset holdings. As the expansion

[13] The Federal Reserve Board publishes an integrated quarterly flow of funds series and the Securities and Exchange Commission publishes regular data on corporate assets and liabilities.

ESTIMATED DISTRIBUTION OF CORPORATE BONDS[a]

	1954		1961	
	$ mn.	%	$ mn.	%
Chartered banks	353	8.4	470	6.5
Life insurance companies	1,407	33.4	1,918	26.3
Other insurance companies	64	1.5	146	2.0
Quebec savings banks	16	0.4	25	0.3
Trust and mortgage loan companies	81	1.9	257	3.5
Pension funds	150[e]	3.5	634	8.7
Provincial and municipal governments	51	1.2	87	1.2
All other resident	592	14.1	1,079	14.8
Total resident	2,714	64.4	4,615	63.3
Non-resident	1,498	35.6	2,670	36.7
TOTAL	4,212	100.0	7,285	100.0

[a]Contains some bonds issued by religious and other bodies.
[e]Estimated.
SOURCE: Bank of Canada *Statistical Summary*.

proceeds, higher inventory and other investment spending leads to an increase in bank loans and other short-term borrowings, a decline in liquid asset ratios which is more important in providing funds than changes in bank loans, and some narrowing of profit margins; it is at this point that most extensive resort is made to longer-term funds and security issues.[14] In Canada, the more restrictive credit conditions induced by these higher demands for funds and by official policies of restraint have usually led in the post-war period to an increase in business financing in the American market, where funds have normally been both cheaper and more readily available.

It is sometimes suggested that the increasing reliance of business on internally-generated funds leads to a greater misallocation and lessened mobility of funds than if more financing and spending plans had to undergo market tests. In an important sense, however, the ability to generate internal funds means that the company concerned has passed the test of buyers in the markets for goods and services. Moreover, market or bank borrowing is important for many corporations and practically all of them either resort to it for at least their marginal needs or are subject to scrutiny by their trade creditors. Finally, the mobility of funds between unaffiliated corporations has been greatly improved by the increased use made of trade credit and by the development of short-term borrowing and lending through the money market and financial institutions.

It is beyond our terms of reference to prescribe the far-reaching changes in the taxation of profits, retained earnings and depreciation necessary to achieve a major reduction in internal funds, even if we had come upon evidence that such changes were desirable. In fact, it appears uncertain whether such changes would lead to a significant improvement in the flows of funds in the economy from low-yielding to higher-yielding uses. In any event, shareholders have it in their power to force an increase in dividend pay-outs, already high by historical standards, if collectively they are dissatisfied with pay-out ratios. Moreover, it is by no means clear that Canadian individuals and institutions would on balance supply more of the equity funds needed for national development if dividend pay-outs were increased. To the extent that such payments were spent on consumption or reinvested in debt obligations, our dependence on non-resident equity capital would be increased.

The increased reliance on internal funds has been characteristic of the mining, oil and gas, and other resource industries which used to depend relatively heavily on the equity markets. The emergence of large mining and oil companies with big holdings of liquid assets has changed the traditional sources of finance, although venture capital raised in the equity markets has continued to be a source of funds for small speculative or exploratory ventures which now account for less than 15% of mining exploration outlays in Canada. The equity markets have also been important for some of the smaller independent

[14] See Federal Reserve Bulletin, June 1963, *Recent Changes in Liquidity*.

oil companies, particularly when share prices were carried to high levels by investor optimism. Some of these small companies have found it relatively difficult to raise equity money with share prices at more deflated levels, but their major difficulty is that their small size and cash flows make it uneconomic to continue as separate entities. As a consequence, there have been many mergers into larger units capable of continuing exploration on the necessary scale. We shall have something to say about the appropriateness of using stock exchange facilities for raising speculative capital in Chapter 17.

Major resource projects involving sales abroad have sometimes proved difficult to finance in Canada because of their sheer size and the large risks entailed for the relatively few Canadian institutions. Moreover, such projects are sometimes more easily financed by those in other countries who hold purchase or marketing contracts with Canadian producers or by institutions more familiar than ours with the financial position of such purchasers. However, this tendency has become less pronounced in recent years—for example a major zinc complex in Quebec has been financed wholly in Canada. The attitudes and skills of Canadian long-term institutional investors will be dealt with more fully in Chapter 13, but in general we do not regard the sometimes heavy foreign borrowing by Canadian business in the post-war period as resulting primarily from deficiencies in the domestic financial markets. Rather, it has stemmed basically from unusually high levels of investment in relation to domestic savings—the financial counterpart of which has been higher interest rates than those prevailing in the United States—and, at times, from inappropriate credit policies in Canada.

In summary, internal funds have become more important as a source of business finance, but the continuing needs of most borrowers for outside finance appear to have been well served by the Canadian financial system in the post-war period. This is true also of co-operatives, which have assets equal to less than 1½% of all corporate business, although they account for more than 50% of grain and seed sales and 25% of livestock and dairy sales. Equity is raised privately from their own members but the larger units are also significant bank and market borrowers. Small co-operatives encounter financing problems similar to those of small business generally, a subject to which we now turn.

SMALL BUSINESS

Smaller businesses, too, have done a sizable amount of their financing internally in the post-war period, although they appear to rely relatively more on outside sources than do the larger enterprises.[15] The variety of outside financing available to small business has also increased markedly: they have made increasing use of trade credit, term loans from bank and non-bank sources, a widened range of lease and rental arrangements, oil and gas production loans from institutional investors, and short-term borrowings from the banks and others. Moreover, in recent years in particular, the instalment finance companies have emerged as a significant source of credit to these borrowers. A few such borrowers have also raised equity, convertible debenture, and long-term debt funds through the capital markets and private placements or have obtained funds indirectly through the use of the export insurance facilities discussed in Chapter 12. Finally, a number of new institutions have been established to meet the special needs of smaller enterprises, including private lending, investing and development companies, the Industrial Development Bank (I.D.B.) and a number of provincially-sponsored loan and development funds.

Despite this increase in the sources of finance available to smaller businesses, we received some representations that facilities were still inadequate to meet their legitimate needs for longer-term equity and debt funds. Quite apart from the natural tendency of all borrowers to believe that they are entitled to more funds on better terms than purely objective considerations would indi-

[15] See the Working Paper, *Financial Small Business*, prepared by F. X. Wildgen of our Research staff.

cate, we found the validity of these views difficult to assess in the light of the conflicting evidence and contrary testimony we received from a number of witnesses familiar with small business. A number of them indicated that the primary problem was one of good management and effective use of existing financial resources;[16] one company with affiliates in many countries indicated that facilities and competition for small business financing were more developed in Canada than elsewhere and claimed difficulty in finding enough satisfactory business;[17] and some witnesses laid stress on the reluctance of the owners of small business to give up any share of the equity of the enterprise by raising funds from common shares, the inadequacy of their financial planning, their ignorance of financing sources, and their inability to sell themselves to lending institutions.[18] On the other hand, 26 out of 65 private companies controlled in Canada having sales under $250,000 annually and responding to a Canadian Manufacturers' Association questionnaire claimed that they were unable to get "sufficient" long-term capital; 42 of 124 similar companies with sales between $250,000 and $1 million also made this claim. Unfortunately, we have no way of knowing how representative was the total of 68 companies so replying or what specific insufficiencies —amounts, rates, or other terms—they had in mind.[19]

Nor does other evidence resolve the question. The fact that small business accounts for between 94% and 100% of the number of enterprises in most broad groups of industries can be taken to indicate either that there are advantages in remaining small or that there are difficulties in becoming large.[20] Similarly, the increase in the share of larger businesses in some spheres—retailing in general and food stores in particular—seems likely to reflect underlying economic considerations and basic consumer preferences as much or more than any inherent difficulties of financing smaller enterprises. Moreover, the owners of many businesses have deliberately chosen not to expand, preferring the resulting independence and freedom from complex management problems. Indeed, it is difficult to define "small business" with any precision: the assets or sales of a small cement plant will obviously be very different from those of a small corner grocery, while the capital needed to achieve a given sales volume varies widely from industry to industry. Taking assets of under $1 million as a rough guide, there are some 440,000 small businesses in Canada; most of them are unincorporated, have assets of under $100,000 and are engaged in retail trade, services and construction.

The primary criterion of whether firms are able to use funds effectively is the return which they earn on them. Here again the evidence on the adequacy of financing facilities for smaller firms is conflicting. Over one-third of unincorporated business and companies with assets of under $100,000 either had losses or earned insufficient income to be taxable, compared to under 25% for companies with assets over $100,000.[21] On the other hand, those companies in the under $100,000 and under $1 million classes which were profitable averaged pre-tax returns of 24% and 19% respectively compared to 14% for the larger firms. Taking all smaller companies as a group, their return on equity was very little below that of bigger companies. The figures may be distorted by the lower salaries of owner-managers of small firms[22] but they seem to suggest that many small firms are highly profitable and could put additional funds to good use. Indeed, the tax statistics indicate that the returns to small business

[16] See, for example, Submissions of the Retail Merchants Association of Canada and of Michael Koerner.

[17] Submission of The Charterhouse Group Canada, Limited and transcript, pp. 1535-48.

[18] E.g., testimony of Canadian Small and Independent Business Federation, Transcript, pp. 1482-90.

[19] Submission of C.M.A.—Appendix Table 10.

[20] The high rate at which new businesses are established and wound up each year is likewise not conclusive evidence of the financing difficulties of well-run smaller businesses. It may simply indicate that it is too easy to establish uneconomic enterprises.

[21] Based on the 1951-60 average experience shown in Taxation Statistics.

[22] Since corporate tax rates on the first $35,000 of income are only 21% it is often advantageous to build up equity by leaving the returns in the business rather than adding to equity from salary income on which higher taxes must often be paid. Similarly, it is usually advantageous for tax reasons to withdraw funds in the form of dividends rather than salaries.

rose in the years prior to 1960 while those of larger firms, as previously indicated, were falling quite sharply. The relatively small number of such profitable firms, however, suggests that the problem of selecting the potentially profitable enterprise is a difficult one.

A possible indicator that smaller firms could productively employ additional long-term funds is found by analysing their financial position. Their working capital and liquid asset ratios are generally somewhat lower than those of larger firms. They also have relatively less equity and long-term debt outstanding, relying more for financing on bank loans and accounts payable. Manufacturing firms with total assets of under $250,000 in 1960 thus had current liabilities equivalent to between 40% and 50% of assets, compared to between 15% and 25% for firms with assets over $1 million. The smaller firms' ratio of long-term debt was under 15%—even lower for small non-manufacturing firms—compared to an average of 20% for most larger enterprises (excluding very big utility firms where the ratio was higher). These figures should be used with caution since they may reflect nothing more than the different characteristics and needs of different-sized firms: for example, the low long-term debt ratios of small business may reflect the smaller need for long-lived physical assets in the type of manufacturing and service industries where small business tends to predominate.

While the evidence is by no means clear, the recent expansion of lending to small business by instalment finance companies, specialized development companies and other private lenders—as well as the pronounced expansion of I.D.B. and provincial lending—suggests that some deficiencies have existed. However, the modest expansion of guaranteed bank loans to small business under the Small Businesses Loans Act of 1960[23] and the complaints we received that the I.D.B. was merely displacing other lenders (a question examined more fully in Chapter 12), also indicate that the problem has been relatively modest. A part of the difficulty may have stemmed from the abnormally high credit demands experienced by lenders up until the late 1950's and seems to have become less severe recently, particularly in the light of the favourable treatment now accorded smaller borrowers by the banks in periods of monetary restraint[24]. Moreover, as we will indicate later in the report, the limitations on the maximum lending rates and on the taking of mortgage security by banks have effectively precluded them from making the charges and taking the collateral necessary to make certain types of loans to smaller enterprises.

Our conclusion is that there has not been a wide gap in Canadian financing facilities for small businesses. In general, short-term lending facilities appear to have been adequate. Moreover, the very smallest firms which account for the bulk of the total appear to have been able to raise all the long-term funds justified by their prospects and experience; these funds typically come from the owner's savings and from loans from relatives, friends, and associates as well as the usual financial and trade sources[25]. Larger-sized enterprises usually have access to a wide range of institutional and capital market sources of funds.[26]. The main problem seems to be encountered by some firms with assets in the range of $20,000-$250,000, and sometimes higher, with borrowing needs scaling up from $10,000 to, say, $100,000. Even here the problem is not of general application and is often a reflection of the need for management advice and guidance as well as finance.

We recognize the risks of lending to "one-man" operations lacking in specialized management and research facilities and we are aware that such firms are often vulnerable to a single unforeseen event because of their lack of size, diversification and financial strength. Nevertheless, we believe that there is still some room for private and public lenders to expand their opera-

[23] On Sept. 30th, 1963, the outstanding amount was only $51 million—a good part of which almost certainly replaced other forms of bank lending.

[24] See Chapter 7.

[25] For example, the oil and automobile companies provide long-term assistance to their dealers.

[26] Those with a speculative appeal have occasionally sold issues at high prices on the stock exchanges.

tions on a selective basis in smaller business financing despite the improvements which have already taken place. We shall later make recommendations designed to encourage such lending in ways which will not deter new and existing lenders who wish to service this field. We wish to draw attention here, however, to the need for more detailed statistical and other information on the financing problems of smaller businesses.

AGRICULTURE

While farming is in many senses a small, family business, its economic position and financial requirements have undergone dramatic changes in the post-war period. The small farm depending heavily on labour and producing much of its own food, fuel and other requirements has given way to larger, more specialized and commercial operations with less labour, high cash expenses and sizable capital investments in machinery, power, fertilizers, and land improvements[27]. This change, as yet far from complete, has increased the efficiency of farms and has been accompanied during much of the post-war period by the movement of people from the farms to higher-paying occupations elsewhere. It was also influenced by technological developments, by shifts in consumer demand for foodstuffs and by greater buyer insistence on uniformly high quality products; these new demands could best be served by large-scale operations concentrating on one or a few products—e.g. broiler or egg production, cattle or hog feeding, turkey ranches, and vegetable or fruit farming. At the same time, farmers have been more willing to make the large investments necessary because farm output and incomes have been stabilized to some extent by government price and income supports, international commodity agreements, relatively strong domestic and world demand, and the new technology itself[28].

The net effect of these developments has been that the agricultural labour force has fallen by half, the productivity of those who remain has risen even more sharply than in manufacturing (although absolute income levels are still only about two-thirds of those in non-agricultural occupations) and the required investment per farm has risen sharply. The typical investment per farm enterprise in 1946 was under $10,000 compared to close to $25,000 currently, but even the latter figure substantially understates the capital outlays required to operate a modern commercial farm. The developments just referred to have greatly widened the gap between the more profitable agricultural units and the majority of smaller, less efficient enterprises. Only 5% of Canada's farms produce an output of more than $15,000 annually, and these units require an investment of from $45,000 to $150,000 or more. Together with another 25% of farms—those with revenues of from $5,000 to $15,000—these units produce about three-quarters of Canada's agricultural output. Their financing requirements are obviously very different from those of the remaining farms, particularly the 60% which have annual sales of less than $3,750. Many of these latter farms are too small or lack the necessary soil quality to take full advantage of modern technology and equipment and may eventually be combined with others, diverted to grazing or other uses, or abandoned.

Since 1946, the value of capital employed in Canadian agriculture has risen by $7.1 billion to $13·7 billion, as the following table shows. These changes in values do not necessarily represent the amount of financing required since they also reflect changing prices, particularly of land. Land in farm use has remained broadly unchanged over the period but its price has risen sharply because

[27] Not all small farms are inefficient, nor all large farms necessarily highly efficient. Acreage alone is thus not an adequate measure—a 40-acre market garden cannot be compared to a 40-acre Western wheat farm. Nevertheless, gross farm revenues are usually a fairly reliable indication of whether a farm is large enough to support advanced productive techniques.

[28] Improvements in pesticides, fertilizers, irrigation, and animal medicine have all played a part in this process. See *Farm Credit in Canada*, prepared for us by D. W. Carr & Associates, for a fuller description of recent trends in agriculture.

CURRENT VALUES OF FARM CAPITAL IN CANADA
(Millions of dollars)

Year	Land and Buildings	Implements and Machines	Livestock and Poultry	Cash Operating Expenses[a]	Total
1946	3,897	905	1,075	785	6,662
1951	5,513	1,932	2,014	1,232	10,691
1956	6,456	2,193	1,423	1,476	11,548
1961	7,694	2,308	2,034	1,699	13,735

[a]Working capital invested in the enterprise.
SOURCE: *Farm Credit in Canada, op. cit.*

of the value of extra acreage to a farm enterprise already well-equipped with machinery.

A 1958[29] survey indicated that farm debt was equal to only 8% of the value of farm investment in Canada, with slight regional variations, although the debt total appears to have been understated;[30] a 1961 compilation puts the ratio at 13%.[31] A 1962 special survey of expanding medium-sized farms showed that the ratio of outside financing to investment amounted to 19%, with the ratio almost 30% in Ontario, Quebec and the Maritimes. This ratio is now about the same as business generally. The low ratio shown for all farms in the 1958 survey reflects the fact that the great majority of all farms have incomes and real investment which are too small to support much outside capital; in many cases, it also reflects the farmer's fears of incurring substantial debt.

Based on the strength in land prices and the increase in farm output alone, it might be concluded that farm credit facilities in Canada are adequate and that additional facilities might lead to further undesirable increases in land values or production. However, the fact that governments have had to play a substantial role in farm credit suggests that some deficiencies have existed. Moreover, the high returns available from expanding the size and capital of many farms, the continuance of many small and unprofitable units in the industry and the strong demand for certain types of credit all point to the possibility of some inadequacies in financing facilities designed to accelerate the trend to larger, more efficient farm units.

The 1958 and 1962 surveys already referred to, while yielding somewhat different results in detail, indicated that short and intermediate term credit accounted for about 40% to 50% of farm indebtedness.[32] The banks have been the dominant source of such credit, accounting for between half and two-thirds of the total through both ordinary bank loans and government-guaranteed Farm Improvement Loans made under legislation introduced in 1944. Most of the latter have been used for purchasing machinery. The rate of interest has remained at 5% despite increases in the banks' prime lending rate from 4½% to 5¾% since inception of the Act. As a result, the banks have no special incentive to make such guaranteed loans despite their favourable loss experience—.12 of 1%. In any event, ordinary loans to farms in September 1963 were half again the size of F.I.L.A. loans. We received representations that the government guarantee is no longer necessary in view of the banks' increased experience and activity in farm lending and that if maintained the interest rate ought to be more flexible to remove its subsidy element and stimulate bank lending. We also received views that it would be helpful to retain the guarantee, increase the individual loan amount, and make repayment terms more flexible. We will comment on these suggestions in Chapter 12 when we review the activities of specialized agricultural lending agencies.

Other sources of short and intermediate term credit are diverse—and a number of them are becoming increasingly important. They include the sales finance companies—a recent entrant in the field but becoming a significant source of equipment and vehicle financing—stores and dealers, farm machinery manufacturers, the Industrial Development Bank, the credit unions,

[29] 1958 Farm Survey Report, DBS.
[30] *Farm Credit in Canada,* Table 16, note 2.
[31] *The Economic Annalist,* Dept. of Agriculture, Ottawa, Feb. 1963, p. 10.
[32] *Farm Credit in Canada, op. cit.,* Tables 16 and 17.

and feed and seed dealers: the feed dealers at times have sums of $100-$150 million outstanding, equivalent to one-quarter of bank farm lending. Private individuals are also suppliers of credit, as are municipalities—for example, for tiling projects for drainage purposes. Moreover, some individual financing requirements are met indirectly by co-operatives which purchase machinery for use by their members, by rentals of equipment, or by contracting certain farm operations such as combining to outsiders.

In general, we have the impression from discussions with witnesses that the financial facilities for providing short and intermediate term credit to farmers are reasonably adequate. Bank loans have grown from $110 million in 1946 to their September 1963 level of $626 million, and other lenders have come into the field to serve the larger operations. However, the banks and other lenders sometimes lack the specialized staff and procedures necessary fully to appraise the risks of lending and assess the management capacity of the borrower. The potential for profitable lending at reasonable rates is thus sometimes incompletely exploited, although to the extent that bank lending to farmers takes place indirectly through the more specialized feed and seed companies this weakness is modified. Some of the banks have introduced special training schemes for personnel or appointed agricultural specialists to their staff to help meet the needs of farm borrowers, but the continuous movement of bank staff through the branch system and the emphasis on other forms of lending often means that bank staff in rural areas lack the special knowledge of their agricultural customers and their problems found in the unit banks in the United States.

There may well be more serious deficiencies in the provision of certain types of long-term credit to agriculture. Private individuals appear to supply about half the mortgage credit recorded, reflecting transfers within a single family, the taking back of mortgages on sale of a farm, and investment by local residents with surplus funds. Private financial institutions, which used to be significant farm mortgage lenders, are now only relatively small suppliers of funds, partly because of the losses resulting from speculative excesses in earlier times and in the drought and depression of the 1930's.[33] They have been discouraged from re-entering the field of farm lending in part because of government long-term lending schemes at what have now become lower than market rates of interest. The federal Farm Credit Corporation since 1959 has made loans of up to $20,000 ($27,500 for supervised loans to farmers 21 to 45 years old) at an interest rate of 5% and has recently stepped up its activities substantially. All provinces also have government programs for extending some form of long-term credit to farmers. The combined loans of all governments now account for over one-third of recorded mortgage credit outstanding, with provincial government lending making up about 40% of the government total. More than two-thirds of the provincial lending is under the Quebec Farm Credit Act which provides for an interest rate of only 2½% and a maximum repayment period approaching 40 years. These arrangements will be examined more fully in Chapter 12.

We received views that the financing provisions for the transfer of existing farms were inadequate and that this was impeding the merger of farm units into larger, more efficient enterprises. The seller often must take back a mortgage repayable over a number of years which—while suitable for many older farmers—may be inconvenient to some. Presumably, expanded credit facilities in this area would lead to vendors obtaining higher sale prices and the new owner acquiring correspondingly more debt. While we are not prepared to make recommendations, it may be that owners of larger farms, like those of non-agricultural business, may need to resort to public debt or equity issues in future to finance expansion and transfer of their enterprises. There have already been a few such public issues of

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[33] Some lenders, however, did not suffer serious losses in the sense that higher rates charged approximately offset the higher bad debt ratios experienced.

very large operations. Other possibilities include long-term leasing of land and buildings from private corporations which might be set up for this purpose (we believe it would be undesirable for government agencies to get into such operations) or the extension of existing public and private mortgage lending institutions to the farm area.

The small low-income farm poses problems of a different nature since it does not appear that such farms could profitably employ additional capital. The problem is rather to develop alternative sources of employment and land use and to facilitate the movement of the persons concerned into higher-paying occupations in both the farm and non-farm sectors of the economy.

CHAPTER 4

GOVERNMENT USE OF THE CAPITAL MARKETS

Canadian governments have become increasingly large borrowers of funds in the post-war period, partly as a result of the expansion of their role in the economy and partly because earlier federal surpluses have given way to deficits requiring finance. Their combined borrowings by way of bank loans and net new securities issues amounted to under $150 million in 1946 but had risen to almost $1,400 million by 1962. The borrowings of provincial and municipal governments alone rose from virtually nothing in 1946 to well over $800 million in 1956, and have remained at about this level. Since the federal government ran substantial cash surpluses over this decade, all governments and their enterprises combined were not heavy users of savings in the period as a whole. However, federal borrowing needs have been substantial in the years following 1957, and the government sector has thus become a major user of savings, its requirements being equal to over half of the saving of individuals. The growing importance of government borrowing is shown by the fact that it has accounted for about 50% of the increase in recorded primary debt outstanding since 1957 compared to 10% from 1945 to 1956.

Governments, like other borrowers, are interested in ensuring that the capital market efficiently transmits savings to them at costs which fairly reflect the risks involved and the competing claims for funds. As buyers of goods and services, governments account for almost 20% of national production and employ directly a sizable share of the Canadian labour force. They also have an important indirect impact on the nature, amount, and growth of economic activity through their monetary, debt management, and other financial policies, through their legislation governing financial institutions and securities issuers and markets, and through their lending and guarantee activities. These and related subjects will be reviewed in later chapters. However, it goes well beyond our terms of reference to attempt to deal with all aspects of government influence on our economic and social life—for example, through the level and pattern of taxes, expenditures, and transfer payments and through government regulations as diverse as zoning ordinances and combines laws.

THE FINANCIAL POSITION OF GOVERNMENTS

The main focus in this chapter is provincial and municipal borrowings, their determinants, and the effectiveness with which the capital markets handle them. Since federal borrowing must be closely related to debt management, fiscal and monetary policies and must be oriented to broader national economic objectives, the main discussion of it is left to later chapters.

Whether governments are net suppliers or users of funds depends on whether their total revenues exceed or fall short of their total expenditures. In practice the normal pattern is to arrive at tentative expenditure decisions—which may be governed by the necessity of economic growth, by public

and social preferences, by statutory commitments, or by shorter-term political considerations—and then to make a decision as to whether to finance these outlays by increasing revenues or by adding to borrowings. This decision in turn is governed by a number of factors: these include the ability or willingness to raise taxation in view of its effects on the growth and revenue prospects of the municipality or province concerned, the financial position of the particular government, its willingness to incur additional debt, and the cost and availability of funds from lenders. These factors in turn may lead to the suspension, curtailment, or slowing-down of the original expenditures proposed.

At the federal level, there must be particular concern with Canada's international competitive position and with the effects of proposed spending, taxation and borrowing plans on national economic stability and growth. Such factors are also becoming of increasing concern to provincial governments in view of the growing role they play in the economy and the contribution which their co-operation can make to the achievement of national goals.

In the event, government expenditures at all levels (net of transfers from one level of government to another) have risen sharply in the post-war period, from just over $3 billion in 1947 to almost $13 billion currently. The growth of provincial and municipal expenditures, which had been held down by the depression and war, has been particularly rapid, and the combined total has risen from approximately $1 billion in 1947 to $6.7 billion in 1962. The federal government's share in the total has thus declined sharply from its wartime peak of 85%, although—at almost half—it is still well above the one-third of all government expenditures for which it accounted in the late 1920's and 1930's. In addition to its own outlays of $6.3 billion, the federal government paid out over $1.1 billion to the provinces and municipalities in 1962 in the form of tax rentals, grants and other transfers.

Chart 4-1 shows government expenditures on goods and services alone, measured on a national accounts basis to reflect governments' direct use of resources.[1] The exclusion of transfer payments, which of course can have powerful indirect effects on income, shows clearly the importance of provincial and municipal expenditures, which are now more than half again as large as federal expenditures on goods and services.[2] Municipal outlays on goods and services remain about twice the size of provincial expenditures; before the depression of the 1930's they were an even higher multiple. They are also more than twice the size of federal non-defence expenditures on goods and services and larger than all federal goods and services outlays combined. Chart 4-2 shows how this has resulted in a steady increase in the proportion of national expenditure accounted for by provincial and municipal spending.

These trends reflect in part a tendency for the outlays of various levels of government to move back towards the position they held before the war, since it is the provincial and municipal governments which provide roads, schools, hospitals, sewers, and other public services required by peace-time Canada. The increasing urbanization, wealth, leisure and mobility of the population has led to a demand for higher standards of services, and the growth of the economy has made heavy capital investments necessary in these traditional areas of government responsibility. At the federal level, continued heavy defence expenditures have been in large part responsible for that government spending relatively more on goods and services than before the war—the relative rise in non-defence categories being small—while some extension of the public sector, particularly in the field of health and hospital services, has also contributed to

[1] These accounts are designed to throw light on the direct economic effects of government spending and differ from government budgets in that they include both current and capital outlays and payments to and from government funds which may not be included in government budgets; they exclude purely book-keeping transactions and transactions in existing assets. Moreover, the national accounts are calculated on an accrual basis rather than when cash actually changes hands.

[2] They had been almost three times federal goods and services expenditures in the 1920's and 1930's.

Chart 4-1

GOVERNMENT EXPENDITURE ON GOODS AND SERVICES

Annually

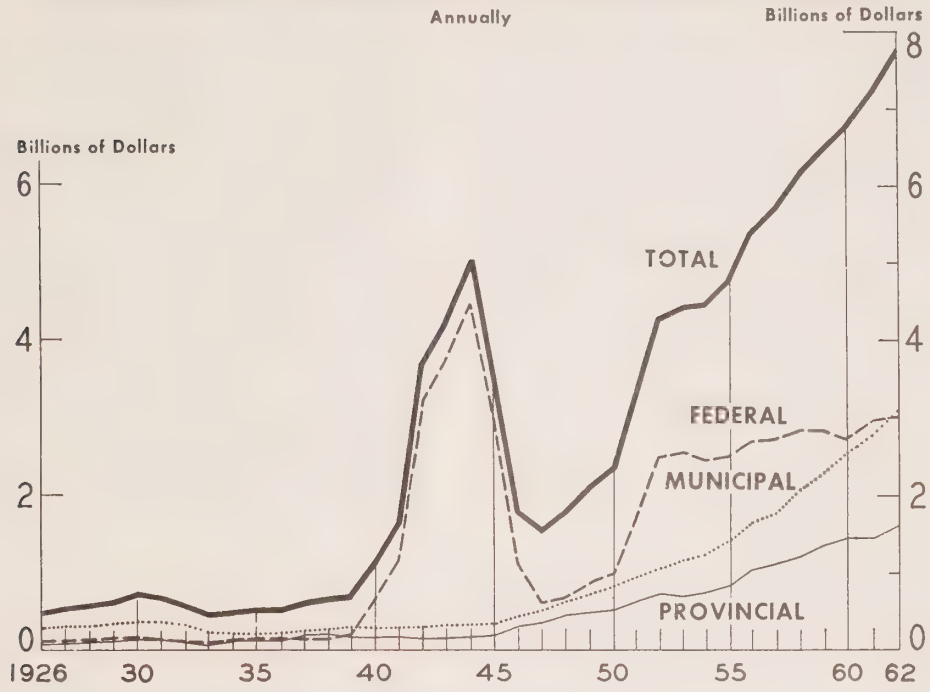
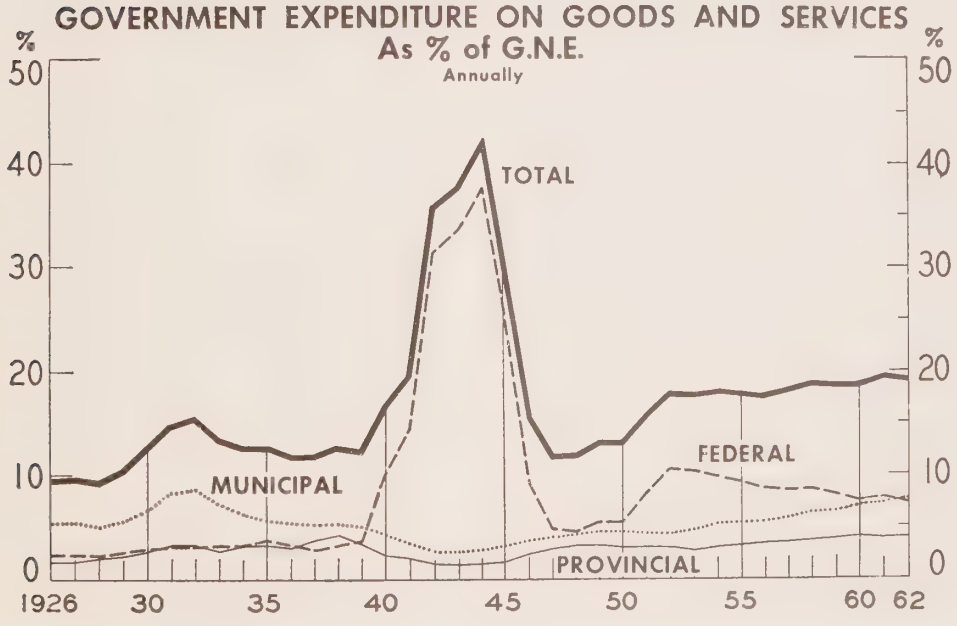


Chart 4-2

GOVERNMENT EXPENDITURE ON GOODS AND SERVICES As % of G.N.E.

Annually



the growing importance of all government spending on goods and services.

The role of provincial and municipal governments in capital spending has grown very sharply since the end of the war. They and their institutions and enterprises now account for about one quarter of all private and public investment in Canada compared to less than a sixth at the end of the war.[3] Federal investment outlays now account for about 8% of national capital outlays of over $9 billion, although they have been higher when large defence facilities or major projects like the St. Lawrence Seaway were under construction. Put in another way, over 20% of all the expenditures of provincial and municipal governments are capital outlays,[4] reflecting their heavy responsibilities for highways, schools, and the other facilities mentioned earlier. In contrast, less than 10% of federal expenditures are for capital investment, partly because transfer payments and defence services, which do not involve continuing heavy government fixed capital facilities, are the major items in the federal budget.

The record of expenditures on goods and services does not reveal the full story of the growing share of government in our national life. As the following table shows, transfer payments to persons, mainly for welfare purposes, have grown extremely rapidly and now account for 9.0% of

[3] If their enterprises are excluded, the current figure is about 17% compared to 12.5% at the end of the war.

[4] Excluding the expenditures and capital investment of their enterprises whose principal revenues are derived from the sale of goods and services to the public.

TABLE 4–1

SELECTED GOVERNMENT EXPENDITURES AND REVENUES, 1928, 1947 AND 1962

	1928		1947		1962	
	$ millions	% of G.N.P.	$ millions	% of G.N.P.	$ millions	% of G.N.P.
Goods and Services:						
Federal Defence	20	0.3	227	1.7	1,680	4.1
Federal Non-defence	118	2.0	402	3.1	1,328	3.3
Provincial	118	2.0	382	2.9	1,606	4.0
Municipal	304	5.0	530	4.0	3,107	7.7
Total Goods and Services	560	9.3	1,541	11.7	7,721	19.1
Transfers to persons:[a]						
Federal	44	0.7	611	4.6	2,122	5.2
Provincial and Municipal	43	0.7	228	1.7	1,530	3.8
Interest Payments:						
Federal	125	2.1	453	3.4	855	2.1
Provincial	43	0.7	68	0.5	419	1.0
Municipal	63	1.0	38	0.3		
Total expenditures[b]	883	14.6	3,116	23.7	12,938	32.0
Total Revenues[b]	950	15.7	3,869	29.4	12,168	30.1
of which:						
Personal Direct Taxes	59	1.0	791	6.0	2,714	6.7
Corporate Direct Taxes[c]	45	0.7	737	5.6	1,875	4.6
Indirect Taxes	684	11.3	1,785	13.5	5,552	13.7
All Other	162	2.7	556	4.2	2,027	5.0
G.N.P.	6,046		13,165		40,401	

[a] Excluding interest on the public debt.
[b] Includes all expenditures and revenues and is net of transfers between governments.
[c] Including withholding taxes.
SOURCE: *National Accounts.*

national product compared to only 1.4% in 1928 and 6.3% in 1947, when the figure was swollen by benefits to returning veterans.

The revenues of all levels of government have increased dramatically since the end of the war, but in recent years have not kept pace with expenditures and have led to deficits which have been covered by capital market borrowing. Revenues collected by all levels of government from the public now amount to $12.2 billion, equivalent to 30% of Gross National Product, compared to $3.9 billion—29% of G.N.P.—in 1947. The federal government's revenues of $6.9 billion are largely made up of direct income and other taxes on persons and corporations, sales and excise taxes, and a small but growing amount of social insurance and pension fund contributions; in general, these sources yield large and rising returns in a growing economy but are sensitive to short-run weaknesses in income.[5] Provincial government revenues are less sensitive to fluctuations in income, being more dependent on gasoline, liquor, property, natural resource, and retail sales taxes and on transfers from the federal government, the latter now accounting for about 30% of their revenues.[6] Municipal revenues are even less sensitive to economic activity, almost half of the total coming from property taxes and a further third from other governments, mainly provincial.

It is not our task or intention to comment on the adequacy of revenues at each level of government, on the arrangements for tax and expenditure sharing between governments or on the impact of the present pattern and level of taxes on economic activity generally. We simply wish to point out that government expenditures must be covered either by revenue or borrowing, that short-run fluctuations in revenues are more likely to occur at the federal than at the provincial and municipal levels, and that the benefits of economic growth do not necessarily accrue automatically to the treasuries of those governments with the heaviest spending responsibilities. Indeed, most of the provincial and municipal government representatives appearing before us argued that their problems lay in the revenue rather than the borrowing field. This was particularly true at the municipal level where it was suggested that property taxes, which are now equal to 4½% of personal disposable income compared to 3% right after the war and 5½% in the late 1920's, cannot be relied upon to meet growing needs.

Whatever the merits of these arguments, the municipal governments, as Chart 4-3 shows—have run steadily widening deficits since the end of the war, the figure amounting to just over $400 million in 1962. The provinces, after running post-war surpluses which in 1953 reached a high point of over $200 million, incurred deficits of just over $90 million in 1960 and 1961. However, a modest surplus re-emerged in 1962, reflecting the taxation measures taken by several governments and the effects of improved economic activity on their revenues. As already noted, the government sector only began to exert a major claim on national savings following 1957 when, as the chart shows, federal government deficits of up to $1 billion replaced earlier surpluses which averaged $440 million from 1947 to 1957.[7] These deficits stemmed both from increased spending—particularly on transfers to provinces and increased welfare payments—and a slackening of revenue gains as national economic progress slowed.

Thus, all levels of government ran deficits amounting to over 2.5% of G.N.P. in 1958-62, equal to about one-third of net personal saving in these years. This contrasts sharply with the 1947-52 period when governments were net suppliers of funds to others, including their own enterprises, of over $3.6 billion, equal to almost two-thirds of personal saving and about 3.5% of G.N.P. in those years. In Chapter 24 we shall discuss the role of federal government deficits and surpluses more fully, and examine the part that the fiscal policy of provincial governments can play in helping to achieve broad economic objectives.

[5] See Chapter 24 for a discussion of their "automatic stabilizing" effect on economic activity.

[6] Including conditional grants.

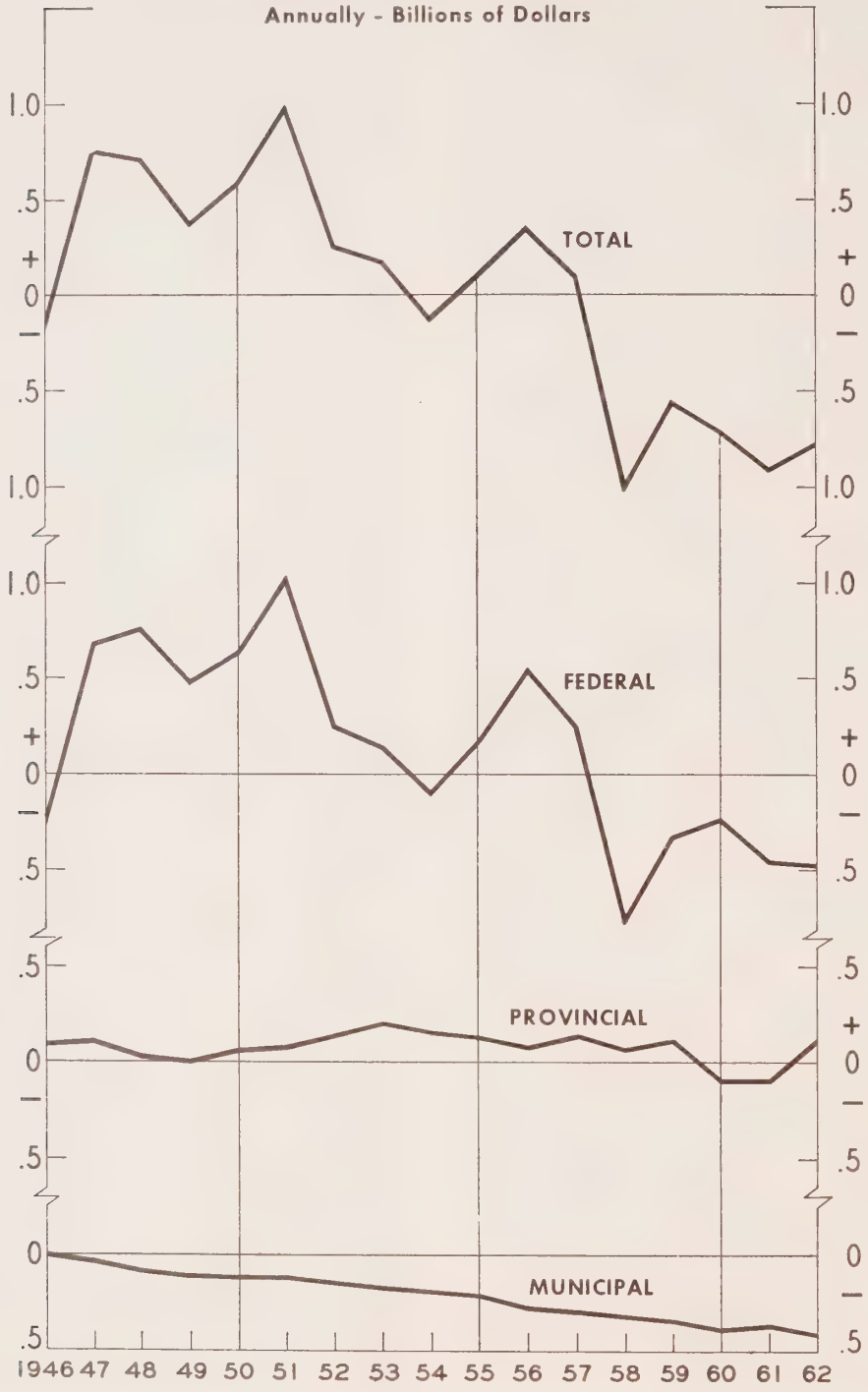
[7] The only deficit in this period was one of $100 million in the recession year of 1954.

Chart 4-3

GOVERNMENT SURPLUS OR DEFICIT

National Accounts Basis

Annually - Billions of Dollars



The figures cited above are from national accounts data which measure governmental contributions to or drawings from the pool of national saving and are on a calendar rather than a fiscal year basis. These data have the merit of treating all government revenues and spending in a uniform way: the budgets presented to provincial legislatures and municipal councils often differ in their accounting techniques, sometimes from year to year, and quite frequently are made up of separate current and capital account budgets to which somewhat different items or proportionate amounts are charged in different periods. Moreover, some governments conduct certain non-commercial operations through separate corporations, the data for which do not appear in budget statements. The reported figures of deficits or surpluses are therefore not always useful in measuring the economic or financial effects of government activities. Although the Taxation Commission will doubtless be dealing with this subject in some detail, we believe provincial and municipal governments would facilitate both their financing and economic analysis of their operations if individual governments were to use a more uniform and simpler classification of revenues, expenditures and indebtedness.[8]

[8] D.B.S., in its publication *Comparative Statistics of Public Finance* puts the provincial data and that of all municipalities combined in each province on a uniform basis. The same degree of comparability for individual municipal governments would be helpful.

In addition to cash requirements arising out of their own operations in goods and services and any transactions in existing securities, governments have needed to raise increasing amounts for crown corporations whose main business is selling goods and services to the public. The gross expenditures and revenues of government entities like hydro-electric, telephone, and transportation systems are not included in either government budgets or in the government sector of the national accounts, but their financial requirements have been growing substantially with the expansion of the economy. Moreover, government ownership of such corporations and other essentially business enterprises has been growing significantly, particularly at the provincial level.

As Table 4-2 shows, indirect debt now accounts for over half the total provincial debt outstanding compared to 8% at the end of the war; over 90% of this was for government enterprises, with municipal and school corporations accounting for most of the remainder. In absolute terms, indirect debt accounted for about two-thirds of the increase of $6.4 billion. At the municipal level, however, indirect debt has been of minor importance, the main factors in the growth of bonded debt from under $900 million in 1947 to over $3.8 billion in 1961 being borrowing for schools and roads. Federal indirect debt has also been small, that government having preferred to borrow mainly in its

TABLE 4–2

PROVINCIAL GOVERNMENTS: DIRECT AND INDIRECT DEBT OUTSTANDING (LESS SINKING FUNDS) SELECTED YEARS, 1945–1961[a]

	1945		1950		1955		1961	
	$ mn.	%	$ mn.	%	$ mn.	%	$ mn.	%
Direct	1,802.2	92.1	2,074.8	73.3	2,552.8	61.6	4,058.1	48.6
Indirect	153.8	7.9	755.3	26.7	1,588.6	38.4	4,293.1	51.4
TOTAL	1,956.0	100.0	2,830.1	100.0	4,141.4	100.0	8,351.2	100.0

[a] Fiscal year end nearest to December 31st.
SOURCE: *Bank of Canada Statistical Summary.*

own name to finance its commercial crown corporations. Total federal debt outstanding, after falling from $17.5 billion in 1945 to $15.2 billion in 1956 and 1957, rose again to $19.4 billion at the end of 1962.

Table 4-3 illustrates how the reduction in total federal debt outstanding up to 1957, together with a build-up of official holdings by the government sector itself, enabled the general public and institutions to run down their holdings. The banks and life insurance companies replaced these securities with loans, mortgages and other higher-yielding assets, while the general public also used these sales to increase their spending on real goods and services. The full extent of the shift in portfolios which occurred in this period can be better appreciated if it is recalled that all other forms of primary debt outstanding increased by about $25 billion while federal debt outside the government's hands fell by more than $3 billion. With the re-emergence of deficits in the years following 1957, public and institutional holdings have increased again. However, public holdings of marketable securities are still well below their 1946 levels, the principal increase having come about in the category of Canada Savings Bonds. At the end of 1962, 24% of the federal debt and 37% of holdings other than those of the banking system and official accounts were in this form: we will return to this subject in Chapter 22.

Despite the large absolute increases in the outstanding debt of all levels of government in the post-war period, it is worth noting that interest charges as a percentage of government expenditure are considerably lower than they were at the end of World War II or in the late 1920's. Chart 4-4 indicates that there has been some up-turn at the federal and municipal levels in recent years —the result of higher interest rates as well as of a larger debt outstanding. It is also interesting to note that in 1961 the investment income of both provinces and municipalities exceeded their interest charges; this income is derived mainly from returns on their enterprises.[9] However, at the federal level, where borrowing for self-sustaining purposes is less important, investment income covered only about one-third of interest charges. In relation to revenues, too, there has been a

[9] Liquor commission profits are excluded from the calculation.

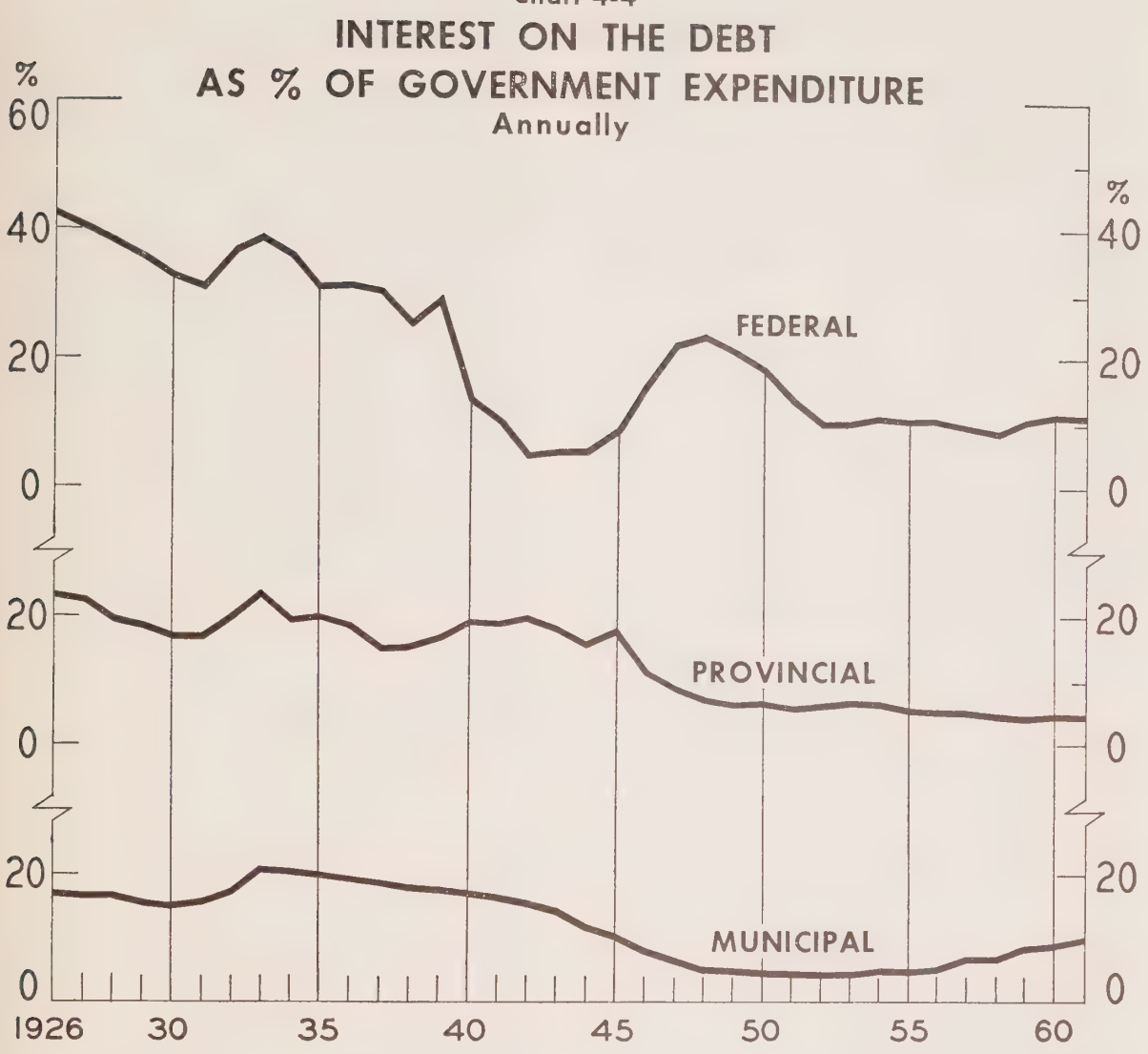
TABLE 4–3

GOVERNMENT OF CANADA DIRECT AND GUARANTEED SECURITIES
ANNUAL DISTRIBUTION OF HOLDINGS

	1946		1957		1962	
	$ mn.	%	$ mn.	%	$ mn.	%
Bank of Canada	1,909	11.0	2,463	16.2	2,936	15.1
Govt. of Canada Accounts	918	5.3	1,367	9.0	670	3.4
Chartered Banks	3,385	19.6	2,641	17.4	3,371	17.3
Provincial Governments	316	1.8	466	3.1	579	3.0
Municipal Governments	129	0.7	53	0.3	76	0.4
Life Insurance Companies	1,766	10.2	538	3.5	677	3.5
Other Insurance Companies	162	0.9	368	2.4	499	2.6
Quebec Savings Banks	77	0.4	39	0.3	32	0.2
Trust & Mortgage Loan Cos.	189	1.1	181	1.2	401	2.1
All other Resident:						
Market Securities	6,160	35.6	3,861	25.5	4,631	23.8
Non-market Securities[a]	1,237	7.1	2,649	17.5	4,620	23.8
Total Resident	16,248	93.8	14,626	96.4	18,492	95.1
Non-Resident	1,065	6.2	538	3.5	957	4.9
TOTAL	17,313	100.0	15,165	100.0	19,448	100.0

[a] In 1946 includes War Savings Certificates and refundable tax: in later years, Canada Savings Bonds only.
SOURCE: Bank of Canada.

Chart 4-4



lessening in the burden of the debt. Direct provincial debt, which was about five times provincial revenues in the late 1920's and more than 2.5 times revenues in 1946 had fallen to 1.1 times in 1960.[10] For municipalities the comparison is somewhat less favourable, the figure being 3 times in 1926 and 1.7 times in both 1946 and 1960; moreover, the ratio has risen somewhat from its low point in 1950. The federal government's total debt was about three times its revenues in 1963 compared to 7 times in 1946 and over 8 times in 1926.

These figures are averages for each class of government and conceal wide differences between individual municipal and provincial governments. Nevertheless, they do not suggest that the debt burden of the provinces has become unmanageable despite the large increase in its absolute amount. The evidence for the municipalities is

[10] Indirect debt is excluded since on balance it is more than self-sustaining.

less clear in view of the recent rise in debt and servicing cost ratios, although the relative burden is much less than in the 1920's and not greatly changed on balance since the end of the war. However, a growing number of municipalities claim that debt charges in relation to income are about as high as they are prepared for the time being to accept, a view which suggests that tax problems rather than lack of financing facilities may at times be the principal source of their difficulty.

THE BORROWING POLICY OF PROVINCIAL AND MUNICIPAL GOVERNMENTS

While provincial and municipal views as to the appropriateness of borrowing vary widely, there is a general tendency for municipalities to finance most capital expenditures by borrowing rather than from current revenues.[11] At the provincial level, perhaps because of the longer term of office of elected officials and because the public seems more willing to accept increased provincial taxation than higher property taxes, there is less tendency for capital outlays to be financed mainly from borrowings. Most governments distinguish between truly self-liquidating projects such as utilities, which can be financed by borrowing without net charge to government treasuries, and projects which are not self-supporting. It can be argued that any municipal or provincial work, a road for example, is to some extent self-liquidating in that it increases property values, encourages new building which raises the municipal assessment base or leads to higher provincial revenues from the gasoline tax. However, most governments realize that if extended too far this reasoning can lead to a comfortable but deceptive rationalization of almost any borrowing and to a serious impairment of their financial position.

One common line of argument in favour of an individual local government borrowing is that the benefits of its long-lived public works will be shared by future generations of tax-payers, and that if long-term borrowing is used these generations will pay part of the cost in taxes to service the debt. Since some of the debt will be held by residents of other communities, there will be a real shifting of costs as well as a transfer from tax-payers to bond-holders within the community itself. On the other hand, future generations will have their own problems of taxation, transfer payments and spending, and there is little to be said for leaving them with an excessive legacy of debt to service. Within the limits imposed by considerations of financial soundness, it is clearly a matter of community choice as to how many unencumbered assets it leaves for the enjoyment of future generations. There is thus no objective measure of what should be financed by borrowing and what by revenues.

Like business corporations, provincial and municipal governments must be prudent in managing their affairs, covering ordinary expenditures and some capital works out of revenues but being prepared to borrow where necessary to finance self-liquidating projects and major outlays which produce a "hump" in their spending programs. Although modest provincial deficits on ordinary account may be appropriate in circumstances of slack economic activity, particularly if substantial earlier surpluses have been accumulated, provincial—and especially municipal—governments must generally follow moderate borrowing practices if they are not to impair their credit standing. This is particularly true in good times, since if an adverse situation should subsequently develop, these governments would then be in a better position to borrow more heavily. As we have already indicated, the financial position of the provinces has strengthened throughout the post-war period, but the municipal position—while broadly unchanged on balance—suggests that an increasing number of local governments are using their borrowing powers about as fully as reasonable prudence will allow.

Unlike federal debt management, which must be closely geared to national financial policies and objectives, provincial and municipal borrowing practices must in our view be governed by somewhat narrower considerations. Indeed, the primary aim of provincial and municipal debt

[11] Most municipalities are precluded by provincial law from budgeting for ordinary account deficits.

management and borrowing policy must be to minimize the cost of their debt. These governments—while not oblivious to broader considerations—should not also be obligated as the federal government must be, to give heavy emphasis to the impact of their borrowing operations on national credit conditions.[12] The obligations of provincial and municipal governments are of course part of the public debt broadly defined, but we will suggest in Chapter 22 that the federal government can in any event vary credit conditions over the range that is feasible without formally co-ordinating its debt management with that of other governments. Moreover, the federal government has more scope than other governments in this field since its debt is almost entirely held by the same broad group which pays the taxes to service it—i.e. residents of Canada. While the taxes necessary to meet interest payments and other debt charges almost certainly have some effects on the distribution of national income and on incentives, the transfer burden to the country as a whole is clearly felt to be less than that applying to the debt service of a particular provincial or municipal government.[13]

THE COSTS OF PROVINCIAL AND MUNICIPAL BORROWING

Chart 4-5, which compares the market yield on long-term provincial bonds with those of corporations, municipalities and the federal government, shows how the cost of borrowing has risen in the post-war period with the rise in general interest rates. The average yield on provincial bonds is above that of the federal government, the difference tending to widen in years of rising interest rates and in years when provincial borrowing was growing while the federal government was paying off debt. In more recent times, the differential has narrowed substantially because of the more moderate growth of total provincial debt, increasing provincial reliance on the short-term market and the increase in the size and term of the federal debt. In contrast, corporate bond yields, which had been well above provincial yields at the peak of business financing in 1957, are now at about the same level.

Among individual provinces, no unvarying standard differentials exist; their credit ratings depend on public confidence in the policies and financial practices of each government, per capita income and the progress of the local economy, and the relative burden of their debt—especially debt which is not self-sustaining. At mid-1963, Ontario yields were about 20¢ above those on Canada's, and Newfoundland borrowing costs were some 50¢ above Ontario, with most other provincial yields clustered close to the Ontario figure.[14] Some provinces suggested to us that the markets seemed slow to recognize fundamental improvements in their credit standing, but it cannot be expected that these adjustments will be accomplished immediately or before purchasers are certain that they represent a lasting change. There has in fact been a dramatic post-war improvement in the relative credit standing of Saskatchewan and Alberta bonds, for example, which reflects the greatly strengthened financial position of those governments.

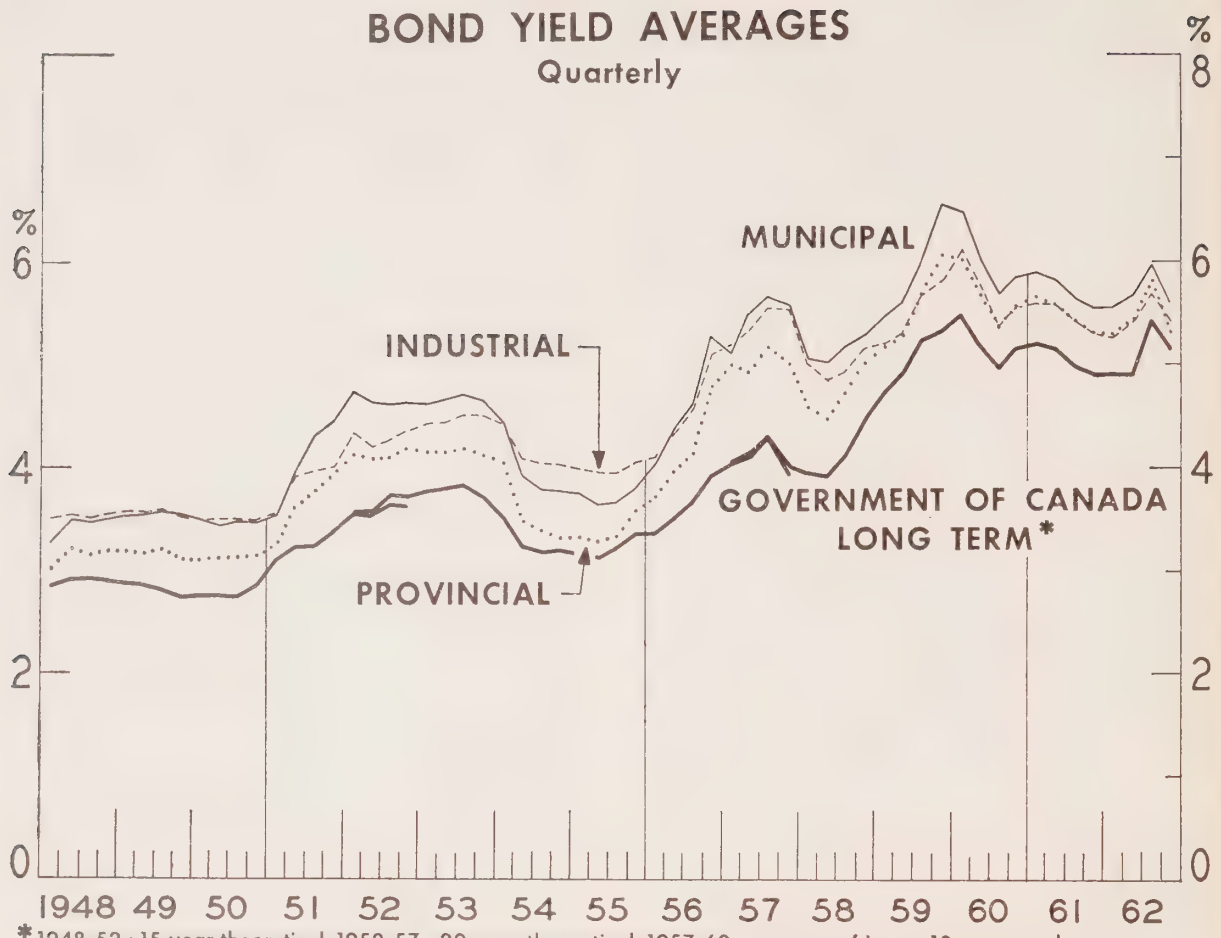
The average municipal yield shown in Chart 4-5 includes only major cities across the country, the bonds of which now tend to sell at yields very little above those of the provinces. The variations in the interest costs paid by individual large cities are typically within a range of 5¢ to 20¢ above the lowest cost borrowers, Ottawa and Metropolitan Toronto. The cost of funds to smaller, less well-known municipalities with a narrower tax base is normally higher, partly because there is no secondary trading market in their securities, although the range of variation is wide. Although comprehensive data on the

[12] In Chapters 24 and 25, however, we suggest that a significant contribution to national objectives would be made if more effective means of co-ordinating spending and revenue policies at all levels of government could be devised.

[13] See, for example, the views of the Provincial Treasurer of Saskatchewan, Transcript, page 633.

[14] After adjustment for differences in call provisions, maturities and other characteristics which affect relative yields.

Chart 4-5



*1948-52 : 15 year theoretical; 1952-57 : 20 year theoretical; 1957-62 : average of issues 10 years and over.
Provincial, Municipal and Industrial averages as compiled by McLeod, Young, Weir and Co. Ltd.

borrowing costs of these issuers are not compiled, a deficiency which we hope provincial governments might remedy, we have obtained considerable material from scattered sources which enables us to indicate the broad pattern of financing costs.[15] In order to ensure comparability, we confined our analysis to 20 year serial bond issues, the most common form of obligation, and calculated the average maturity as 10½ years.[16]

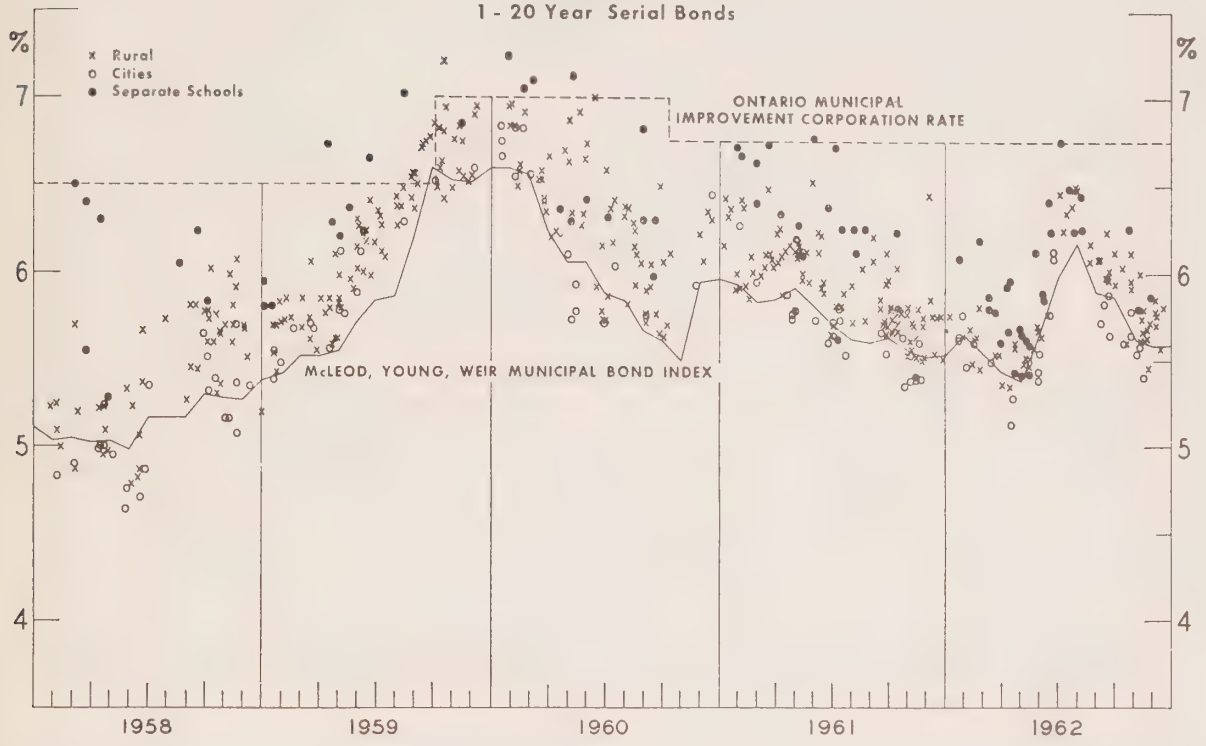
Chart 4-6 shows this data for Ontario municipalities for the period 1958-62, grouped into three categories: urban municipalities—all incorporated cities except Metropolitan Toronto; rural municipalities—towns, villages, townships and counties; and separate school boards.[17] The tendency for urban municipalities to have the lowest costs can be clearly seen; many rural municipalities tend to pay 10¢ to 30¢ more in yield for their funds, while separate school boards with

[15] We particularly wish to acknowledge the kind co-operation of Dominion Securities Corporation Limited and Wood, Gundy & Co. Ltd. for making data available to us.

[16] Many serial issues do not have equal annual maturities, but the effect on the average maturity of these issues is not normally substantial.

[17] Individual borrowings rather than indices are plotted because of the limited number of issues at any point in time. Provincially-guaranteed issues are excluded to ensure comparability, except where noted.

Chart 4-6
MUNICIPAL BORROWING COSTS
Ontario
1 - 20 Year Serial Bonds



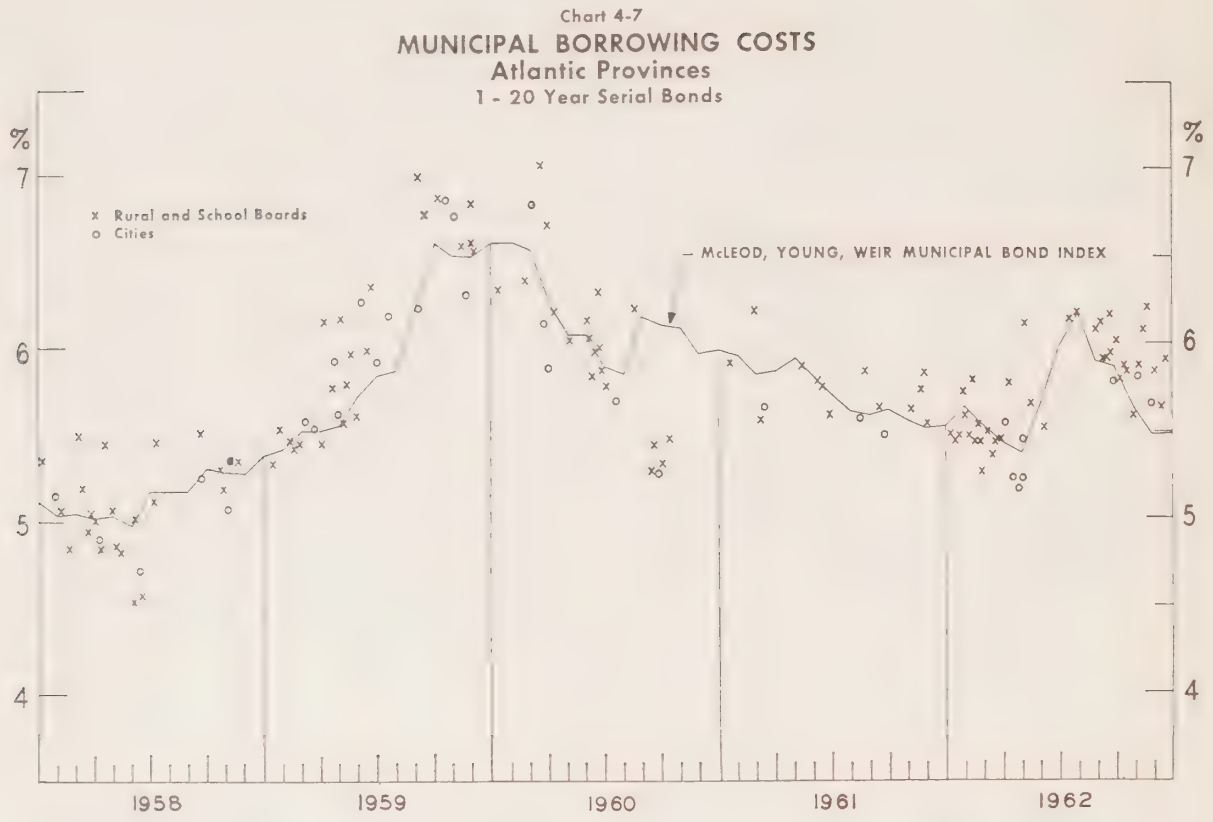
their narrower tax base usually pay 50¢ to 75¢ more. However, as can be seen from the chart, there is considerable variation in the pattern, with some rural municipalities paying less than major cities and some paying a full 1% more; similarly the extra costs of separate school boards ranged from virtually nothing to over 1¼%. The population and tax base are clearly only some of the factors entering into market assessment of municipal credit ratings: past and present debt burdens, the default record, efficiency of administration and market familiarity with the borrower are also important considerations. The rate of the Ontario Municipal Improvement Corporation, the provincially-operated lender of last resort, is also shown on the chart; its activities doubtless check the normal tendency for borrowing spreads to widen in periods of rising general interest rates.

Chart 4-7 shows comparable data for the Atlantic Provinces[18]; it will be noted that differences between urban and rural municipalities are virtually non-existent, partly because the distinction itself is less pronounced. Moreover, the absolute level of borrowing costs is generally lower than in Ontario and is often lower than the cost to major cities elsewhere. These relatively low costs reflect the highly developed local market, which results from trustee laws favourable to municipal securities and from provincial government purchases of municipal issues.

Our statistics for Western Canada are much less adequate, partly because the activities of Alberta's Municipal Financing Corporation make

[18] No observations from Newfoundland are included, the provincial government tending to undertake many of the functions performed elsewhere by municipalities.

Chart 4-7

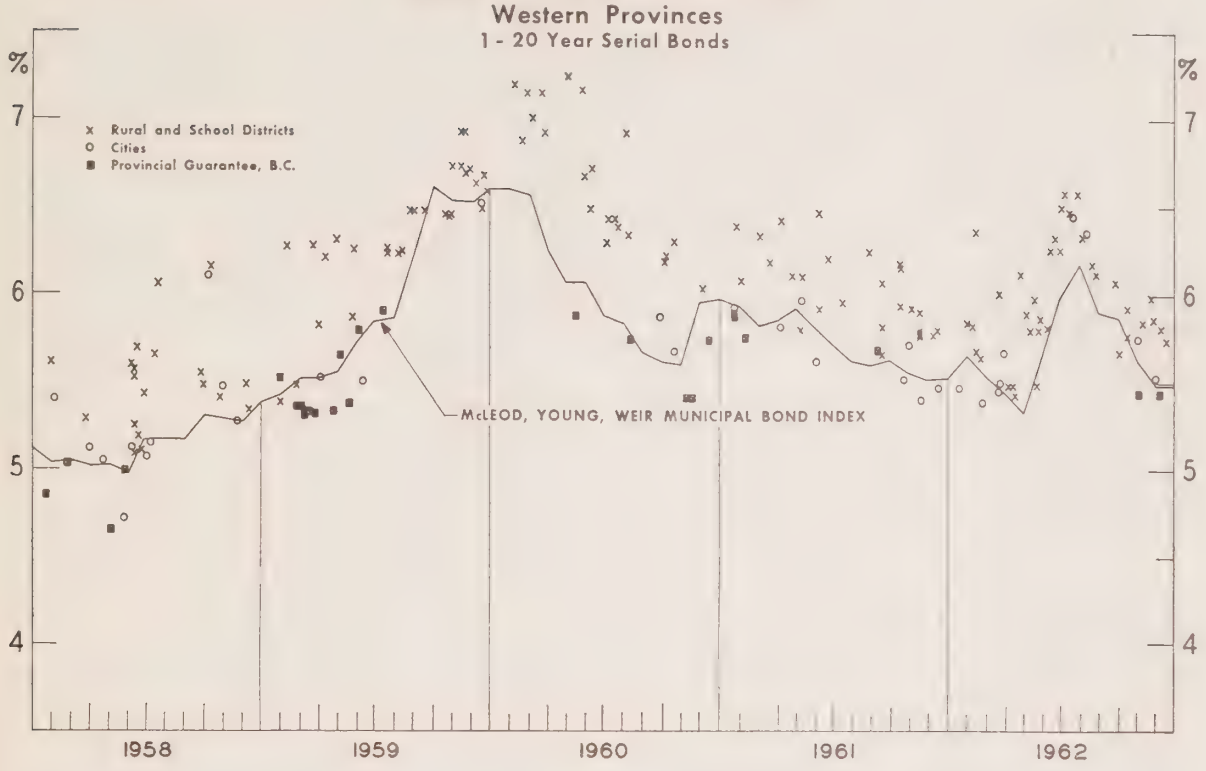


direct municipal borrowing largely unnecessary in that province, and partly because many local issues in the other western provinces are privately placed with no public announcement of their cost. The figures are also influenced by the widespread use of provincial guarantees in British Columbia for certain purposes; some such guaranteed issues are shown on Chart 4-8 for comparative purposes. The effects of this guarantee in lowering the cost of funds to rural municipalities are clearly apparent, as is the tendency for rural borrowing rates to cluster about 30¢ to 50¢ in yield above those for urban municipalities and major cities. Once again, however, there is considerable variation, but the general cost structure appears to be more comparable to that in Ontario than to that in the Atlantic Provinces.

The Quebec data are not portrayed, but the highly-developed retail market and substantial caisse populaire purchases of shorter maturities tend to keep overall costs to levels broadly comparable with municipalities in Ontario: the very small localities, however, on occasion pay relatively more for funds.

These data on provincial and municipal borrowing costs in the Canadian long-term market lead us to believe that the broad pattern of market rates is a rational one which takes account of differing and changing conditions. There is, however, no absolute yardstick by which to measure the appropriate rate for a government with a given borrowing need, debt burden, and revenue base. We received a complaint from the Saskatchewan government that its municipalities seemed to have to pay more for funds than other borrowers with comparable records, but other provincial governments told us that similar difficulties had disappeared when efforts had been made to familiarize buyers with the municipalities' financial and economic position, to present their financial statis-

Chart 4-8
MUNICIPAL BORROWING COSTS
Western Provinces
1 - 20 Year Serial Bonds



tics in a clearer, more comprehensive and uniform way, and to assist them in negotiations with investment dealers and lenders. We believe that more could be done along these lines in many provinces. The resulting improvement in the market's knowledge and information could make a helpful contribution to some lowering of the borrowing costs of smaller and more remote municipalities.

SOURCES AND METHODS OF FINANCE

(i) *The Markets Tapped*

The cost and availability of funds to governments depends on the variety of obligations issued and the number and breadth of markets tapped. Table 4-4 shows the distribution of holdings of provincial and municipal bonded debt, both direct and guaranteed, which accounts for over 90% of their total financing.[19] Provincial government sinking and superannuation funds and other special funds such as workmen's compensation boards are now the largest single holder of outstanding provincial debt, but long-term investors, particularly pension funds, have also increased their holdings substantially. At the same time, bank holdings of provincial debt have declined sharply in relative importance, reflecting the emergence of competing demands for funds and the tendency of provincial governments to issue longer-term securities; bank purchases are generally in the shorter maturities, while trust and loan companies are significant buyers of medium-term maturities as well. All other Canadian buyers have increased their provincial holdings substantially.

[19] The distinction between direct and indirect debt is not always sharp; about one-third of direct provincial debt has been incurred to make loans to provincial utilities and other self-sustaining enterprises.

TABLE 4–4

DISTRIBUTION OF HOLDINGS OF PROVINCIAL AND MUNICIPAL DIRECT AND GUARANTEED BONDS

	PROVINCIAL						MUNICIPAL					
	1947		1954		1961		1947		1954		1961	
	$ mn.	%	$ mn.	%	$ mn.	%	$ mn.	%	$ mn.	%	$ mn.	%
Chartered Banks	448	21.7	264	6.8	352	4.3	133	15.1	177	9.0	231	6.0
Provincial Governments[a]	356[e]	17.2	783	20.2	1,932	23.6	22[e]	2.5	106	5.4	295	7.7
Municipal Governments[b]	30[e]	1.5	26	0.7	103	1.3	1,24[e]	14.1	112	5.7	246	6.4
Life Insurance Companies	198	9.6	354	9.2	823	10.0	1,06	12.0	328	16.6	601	15.7
Other Insurance Companies	45	2.2	130	3.4	283	3.4	32	3.6	63	3.2	129	3.4
Quebec Savings Banks	36[e]	1.7	68	1.8	89	1.1	19	2.2	47	2.4	44	1.1
Trust & Mortgage Loan Cos.	25	1.2	75	1.9	160	2.0	17	2.0	48	2.4	89	2.3
Pension Plans: Industry					495	6.0					246	6.4
Other					155	1.9					16	0.4
All other Resident (Residual)	378	18.3	1,198	31.0	2,031	24.8	164	18.6	657	23.4	906	23.6
Total Resident	1,516	73.4	2,898	75.0	6,423	78.4	617	70.0	1,538	78.1	2,803	73.0
Non-Resident	551	26.6	965	25.0	1,769	21.6	264	30.0	431	21.9	1,036	27.0
TOTAL	2,067	100.0	3,863	100.0	8,192	100.0	881	100.0	1,969	100.0	3,839	100.0

[a]Provincially guaranteed Municipal bonds are included with Provincial rather than Municipal debt.

[b]Including sinking funds.

[e] Estimated

NOTE: These figures differ from those shown in Table 4–2. The former includes all debt, not just that in bonded form, is net of sinking funds, and relates to a different time period (fiscal year-ends nearest to Dec. 31, 1961).

As to municipal bonded debt, provincial governments and their funds have become increasingly important purchasers, mainly as a deliberate attempt to help in the financing of their local governments. Insurance companies, pension funds and other long-term investors have also increased their share of holdings, while the proportion held by banks has declined, although not as sharply as in the case of provincial bonds. The municipal governments' own holdings have declined as well, mainly because they were in an unusually liquid position at the end of the war.[20] Holdings by individuals have risen slightly less rapidly than in the case of provincial bonds, partly because small municipal issues in serial form are not as attractive to private investors. While size is not the only factor, it is generally true that the larger municipalities with skilled financial officers, large and continuing borrowing requirements, and well-prepared financial and other information have a wider individual and institutional market open to them than do municipalities which require long-term finance only infrequently and then perhaps for amounts of $40,000 or less. Indeed, many of the large municipal units have requirements as big or bigger than some of the smaller provinces and enjoy better credit ratings in financial markets.

The bigger units also have better access to foreign markets: the seven largest borrowers account for almost 80% of all foreign currency municipal debt outstanding compared with only 40% of all municipal debt. The evidence we have gathered suggests that provincial and municipal governments resort to foreign markets for a significant proportion of their financing when the Canadian cost and availability of funds is relatively unfavourable, whether due to

[20] Holdings of their own bonds are normally well below provincial holdings of provincial securities since municipal issues are now usually in serial form and thus no longer have sinking funds. In addition, many municipal employees, teachers for example, contribute to pension funds run by provincial governments.

deliberate policy or to heavy competing demands for credit. On occasion, too, individual governments have felt that they could obtain a relatively higher credit rating in the American market than in Canada or that major Canadian institutions have been temporarily unwilling to add to their holdings of that particular government's obligations regardless of price. The latter is the result of conventional investment practices adopted by some Canadian lenders in order to guarantee diversification of their portfolio. While far from rigid and subject to major change over time, these practices have led some borrowers to keep cultivating the American market so that it will always be open to them as a major alternative to Canadian sources of funds.

As Table 4-4 shows, non-resident holdings of provincial government obligations have actually declined as a percentage of the total over the post-war period. Despite the extensive resort to that market in periods of Canadian credit stringency such as 1956 and 1959,[21] under 22% of outstanding provincial bonds are now held by non-residents compared to about 27% in 1947 and no less than 59% in 1930. Most of these are held by Americans, largely through institutions, although minor borrowings have taken place in other countries such as Switzerland. In contrast, non-resident holding of municipal bonds—while well below their prewar proportion and somewhat below that in 1947—increased in importance in the years 1956-1960 when heavy municipal borrowing requirements and tight credit conditions in Canada led these governments to sell an average of about $100 million annually of net new securities issues abroad; since 1960, however, municipal use of the non-resident market has declined sharply.

The reduced reliance of provincial and municipal governments on the American market since 1960 reflects the easing of credit conditions in Canada, extension by the federal government in December 1960 of the 15% withholding tax on foreign currency issues,[22] and—in the period between late 1960 and early 1962—official discouragement of such borrowing by Ottawa and fears of an adverse movement in the exchange rate. In mid-1963, the American government announced a graduated tax on longer-term foreign borrowing in the American market and subsequently proposed a qualified exemption for Canadian new issues. At the time of writing, these measures had not become law and their impact on provincial and municipal government borrowing in New York cannot be assessed, although the net effect is likely to be to a diminished reliance on external markets.[23] The interim consequence has been to bring virtually all borrowing in New York to a halt because of uncertainty connected with the legislation, which is to be retroactive to the summer of 1963.

Most external borrowing is denominated in foreign currencies—mainly because most American buyers are unwilling or unable to hold large amounts of securities in other than U.S. currency —and the Canadian issuers thus assume an exchange risk. Since a change in the Canadian price of American dollars will alter the effective cost of servicing this debt, provincial and municipal governments usually resort to external markets only if there is a sufficiently large interest-cost saving to offset the probable risk of adverse exchange movements. While no one government has a rigid rule on this subject and while there are differences between governments, interest-rate differentials in excess of .50% will normally induce some borrowing in U.S. markets. Much depends, however, on the level of the Canadian dollar and of interest rates: the higher each is, the greater is the absolute differential required.

The exchange risk on long-term foreign borrowing can be easily exaggerated since it takes

[21] In early 1963, Quebec raised $300 million in New York to help finance the unusually large sums involved in provincial acquisitions of privately-owned electric utilities.

[22] Buyers such as U.S. pension funds who were not subject to U.S. income taxes tended to cut back their purchases because they could not offset this higher tax by a reduction in U.S. tax liabilities. In the June 1963 budget, an exemption from Canadian withholding taxes for these non-profit institutions—which account for perhaps a third of the normal market—was announced.

[23] See Chapter 23 for a further discussion.

a major exchange rate change to eliminate the savings from substantially lower interest rates abroad. For example, if Canadian interest rates were 5% and American borrowing costs 4% with the Canadian dollar at par, the U.S. dollar would have to go to a premium of 14% in Canadian funds immediately after the proceeds of the issue were repatriated, and remain at this level throughout the life of the issue in order to offset the cost advantage of borrowing abroad on a 20 year bond.[24] The decline in the value of the Canadian dollar would have to be a good deal more if the value of the dollar did not fall until a few years before maturity. Moreover, regular sinking fund or serial payments allow an averaging of the exchange risk, while some flexibility in call dates permits the issue to be paid off somewhat in advance of maturity if less favourable exchange developments are anticipated.

We therefore see no reason on cost and market grounds to oppose foreign borrowing by provincial and municipal governments, especially if governments are careful to include a notional reserve for the risks involved. Obviously there can be no unchanging rule as to the proportion of liabilities which a particular government should have in foreign currencies since the probable risks and cost savings will vary from time to time with relative interest costs and exchange rate changes. Governments should nevertheless continue to avoid excessive risks in this area and ensure that foreign borrowing is not used as a mechanism for incurring an unmanageable burden of total indebtedness. We also believe that provincial governments should ensure that smaller governments which lack financial skills do not resort to foreign currency borrowing unless the probable benefits outweigh the risks involved. These comments do not, however, apply to the sale of Canadian currency obligations to foreign investors, a number of whom have developed a particular interest in higher-yielding Canadian-pay municipal obligations.

[24] This calculation assumes that there is no sinking fund on the issue—the advantage is reduced in the circumstances assumed if there is a sinking fund or serial feature. On a 20 year serial issue, for example, the U.S. dollar could only go to an immediate premium of 9%, rather than 14%, before the cost advantage would be lost.

It is sometimes argued that because the provinces and municipalities do not directly contribute to the nation's foreign currency earnings they should not borrow abroad. Quite apart from the indirect contribution which their spending on education and social capital facilities may make to our domestic growth and international competitive position, there is no good reason why every user of foreign exchange should generate his own requirements.[25] The principal purpose of any market, including the exchange market, is to transfer ownership—in this case of foreign currencies—from those with excess supply to those with unsatisfied demand. These transactions will normally benefit both parties and the economy generally, although there could be circumstances in which the nation's total external indebtedness became excessive. The provinces and larger municipal governments have, however, shown themselves aware of broader national considerations when the federal authorities have made a reasoned case, and we do not believe that it is necessary or desirable to impose arbitrary rules on their external borrowing in the usual course of events.

In order to minimize borrowing costs and increase the availability of funds, many provincial and municipal governments have resorted increasingly to short as well as long-term sources of funds. Bank loans have remained a minor source of finance for provincial governments, partly because they have developed alternative and cheaper sources of short-term funds. Borrowings from banks fluctuate seasonally and tend to reach a high point in December, but for the year as a whole averaged only $30 million in 1962, equal to less than ½ of 1% of all provincial debt; a further modest amount of overall debt was represented by provincially-guaranteed bank loans to their own enterprises, farmers and businesses. However, municipalities, particularly the smaller ones with fewer alternative sources of short-term finance, rely on bank loans to a greater degree and for somewhat longer periods, although they are also used to meet the seasonal variations between tax-collections and expenditures. Thus municipal

[25] To balance the market in such circumstances would involve every earner of foreign exchange in spending it all abroad.

bank borrowing in 1962 fluctuated between a low of $235 million and a seasonal peak of $350 million in the spring; for the year as a whole it represented about 7% of all outstanding municipal debt.

Other short-term debt, mainly in the form of accounts payable and accruals, is relatively unimportant for municipalities, although some of them have been raising funds by the sale of tax-anticipation notes to tax-payers and other non-bank sources; some of the larger centres have also begun to issue treasury bills or other paper in the short-term money market. The provinces, mainly because of their larger size, have become much more active borrowers in the short-term market, two of them auctioning a regular weekly series of treasury bills and a number of them selling comparatively short-dated securities to institutions on a private placement basis. Borrowing from trust funds and by way of deposits accumulated in provincial savings offices is also important in some cases. Nevertheless, all forms of short-term borrowing—including payables and accruals—represent under 10% of total indebtedness at the provincial level.

The published figures, however, understate the importance of provincial short-term borrowing because the funded debt includes some bonds which are redeemable at a fixed price immediately, or on short notice, at the option of the holder. These "savings" or "parity" bonds in Manitoba, Saskatchewan and Quebec are tailored to provide a convenient investment for resident individuals and small corporations, are available in small denominations and contain restrictions as to any buyer's total holdings of each issue;[26] they also provide the holder with higher effective yields if held for an extended period or to maturity. In British Columbia, however, where the present government as a matter of policy does not issue direct debt and where parity bonds are issued by crown corporations subject to government guarantee, there is no limit on holdings by either residence or amount, and no premium for long-term holdings. Alberta and Ontario effectively borrow similar funds through deposits in provincial savings offices while Prince Edward Island raises a limited amount of such funds through the issue of Deposit Receipts; these are included in the short-term borrowings discussed above. Savings bonds or parity bonds now account for over 5% of provincial bonded indebtedness, although the figure is as high as 17% in British Columbia.

We see no reason why such obligations should not be issued by provinces in reasonable amounts or why the savings bond market should be the sole prerogative of the federal government. Yet we also believe that care should be taken not to over-balance the provincial or municipal debt structure with what are essentially demand obligations. Some of the immediate cost savings from issuing such obligations can, as at least one government has found out, be lost if rising interest rates force the issuer to raise the coupon on outstanding issues to prevent large-scale redemptions; the same would be true if old issues were "rolled over" into newer issues paying a higher rate of return. This is because the rates paid on these bonds—while below those on long-term market issues—are above those on comparable short-term liabilities; they are thus only an economic source of finance if they are not redeemed in the short run. The risks of such redemptions can be minimized when the issue contains provisions designed to encourage long-term holdings and to prevent large purchases by interest-sensitive buyers.

(ii) *Techniques of Issue*

The overall cost of marketable debt is affected by the techniques and timing of its issue. Sales to underwriters through competitive tenders or on a fiscal agency basis are the standard marketing techniques, although considerable variation has developed in recent years. Thus, some governments have a fiscal agency agreement but specifically exclude short-term securities from that arrangement, while in other cases competitive tenders are called but only a few underwriters are invited to bid; this avoids the risk of the issue

[26] $25,000, $15,000 and $10,000 in Manitoba, Quebec and Saskatchewan, respectively.

being won by a group that cannot market it adequately. Private placements, in which the government itself or a dealer acting as its agent negotiates the sale directly with institutional or other large buyers, are also becoming increasingly common. This method saves an underwriting fee—the dealer being paid only a small selling commission—and is used particularly for short-term issues and in sales to American buyers. Two provinces have also experimented recently with a system similar to that employed by the federal government in which the government or one of its agencies acts as the underwriter or distributor, paying a modest commission to banks and investment dealers who obtain subscriptions to the issue. Some small and medium-sized municipalities also market their securities directly to individual and other buyers in their own local area.

We discussed the relative merits of fiscal agency and competitive tender methods of marketing with both the governments concerned and the securities industry. In general, provincial governments have swung over to fiscal agency arrangements in recent years, while most municipal governments have remained with the tender system, frequently because the provinces require that they obtain competitive bids to minimize their borrowing costs and prevent any abuses in connection with the sale of their securities. It is recognized that a fiscal agency may not always minimize borrowing costs, but some provinces have felt that a fiscal agent will take care to minimize adverse market developments which might affect their long-run credit standing and will be more successful in building and maintaining investor interest in their securities than would dealers with a less close relationship to the issuer. It is, however, far from clear how far these arguments can be carried, especially since provincial and municipal sinking and other funds are the major instruments of market stabilization in any event. Moreover, all underwriters—no matter how they win an issue—will be interested in creating a market and institutional investors normally make an independent assessment of the securities involved.

It is also argued that a fiscal agent can provide continuing market advice and guidance, particularly on the timing of issues, although the financial officers of the provinces and major municipalities have many other sources of information as well. These officers cannot afford to try to time their issues to catch only the most favourable market circumstances; while they have some room to manoeuvre, it is limited by their need to obtain large amounts of funds at frequent intervals. Finally, it is suggested that competitive tenders occasionally lead to over-enthusiastic bidding and consequently to an unsuccessful or slow-moving issue which damages the issuing government's credit rating—events which are more unlikely with negotiated issues which therefore prove cheaper in the long run. Whether occasional errors of judgment do have such lasting effects and whether they are inevitably more frequent in competitive tenders is open to question, but many provincial governments have been persuaded by such arguments.

While the difference in the costs and benefits of the two methods of issue are probably not as great on balance as is sometimes thought we think it would be unfortunate if provinces and larger municipalities did not call for at least occasional competitive tenders. This practice, which is the general rule in the United States, should help to prevent the growth of any imperfections or lack of competition in the issue of government securities and lead to more flexibility in underwriting syndicates.[27]

(iii) *Modifications to Existing Facilities*

In the course of our hearings, we received a number of suggestions for improving the financial or borrowing position of provinces and municipalities. Many of these went beyond our terms of reference and involved further shifting of expenditures and revenues from one level of government to another or the granting of outright subsidies to favour these governments at the expense of private borrowers and the federal

[27] See Chapter 16.

government.[28] We also received a proposal that the Bank of Canada should finance the social capital requirements of the provinces and municipalities either directly or through re-discount facilities, a proposal which would involve major changes in that institution's operating practices and have profound consequences on its ability to promote national objectives. Financing on the scale envisaged could only be supplied by the central bank if price stability were sacrificed, and even on a smaller scale would subject the central bank to intolerable pressures from eleven competing governments.[29] For the latter reason also, we do not believe it necessary or desirable for the central bank to act as an underwriter to these governments, especially in view of the full facilities available in the private sector.

In general, the credit standing of the provinces and larger municipalities is high, the cost of funds to them compares favourably with that paid by other borrowers and the case for any changes in capital market practices or institutions does not rest on economic grounds. However, some of the smaller or less well-known municipalities—although only a minority of them—do seem to have more difficulty in raising funds without some form of provincial assistance than their basic financial position would indicate. These problems occur despite provincial control over municipalities designed to keep debt reasonable in relation to assessment, and despite provincial marketing guidance which in some cases extends to centralizing municipal tender calls, advice on the timing of issues and even—as in Nova Scotia—scheduling of borrowing to insure a smooth flow of municipal issues. As already suggested, provincial governments could help to alleviate some of these limited municipal borrowing difficulties by extending their marketing assistance and by helping local governments to prepare uniform and up-to-date financial and other statistics. Some witnesses also suggested that institutions and others should establish a rating service for municipal credits similar to those which exist in the United States. We doubt, however, that it would be economic or widely used, and it might lead to an unduly inflexible approach on the part of those buyers who did rely on it.

Some provinces help to reduce municipal borrowing costs through government purchases of municipal securities, particularly slow-moving issues, although some commitments are occasionally made before tenders are called. Some provinces also make annual grants for certain types of municipal capital works, especially schools, and the pledge of these regular payments assists the borrower to raise funds at reasonable rates without involving the province in an explicit guarantee. Both these techniques have the advantage of helping municipalities while encouraging financial responsibility on the part of these governments, since the price they pay for funds reflects their own credit standing and financial positions.[30] Some provinces, like Ontario and Nova Scotia, also run special funds which act as lenders of last resort where needs are urgent and funds are otherwise unavailable or unusually difficult to obtain.

Provincial governments also help to lower the cost and increase the availability of funds to municipalities by guaranteeing their issues. However, such guarantees, by creating a contingent liability and in effect enlarging the provincial debt, tend to weaken provincial credit and involve extending provincial control over the municipal governments' financial affairs. As a result, most provincial governments are very selective in their guarantee policy and some have abandoned it altogether. Thus, while the amount of municipal bonded debt subject to provincial guarantee rose from 1% in 1952 to about 5% in 1961, most of the increase occurred in the province of British Columbia, and under 10% of

[28] In this connection, we received views that the financing problems of provincial governments were made more intense by delays in payment of the federal share of joint-cost programs. This is not a major element in provincial financing requirements, but we hope it will receive the attention of the Tax Commission.

[29] Net Bank of Canada purchases of all government securities, which are of course governed by monetary policy considerations, averaged $90 million annually from 1957 to 1962.

[30] This, of course, is not true when grants are greater to poorly-managed than to well-managed municipalities.

all provincial guarantees were incurred for local government authorities. However, one provincial government—Alberta—has established a special corporation which raises funds under provincial guarantee and uses them to purchase municipal issues, thereby consolidating and pooling municipal borrowing. This naturally involves relatively close control of the financial practices and spending of the borrowing municipalities.

Finally, certain municipal projects like sewers and waterworks are eligible for loans from the federal government at rates just above those paid by that government for its own borrowing. The recently established Municipal Loan Fund will extend this program by lending municipalities up to two-thirds of the cost of capital and reconstruction works which would not otherwise be undertaken at this time. Amounting to $400 million in total, the fund will be divided provincially according to population and 25% of principal repayments will be forgiven if the approved project is completed before April 1, 1966. Thus, one-sixth of the principal costs of the project will be borne by the federal government.

The extent of the incentive provided by the Act can be illustrated by an example. A municipality which undertakes a project costing $1 million would, in the absence of the Act, have had to pay a rate of, let us say, 6% for a 20-year issue. If payments of interest and principal were averaged over the period of the loan, its annual payments would have been $87,180. If, however, the project qualifies under the Municipal Development and Loan Act, the municipality can borrow up to two-thirds of the cost from the Board at a rate which shall not be more than one quarter of one per cent above the effective interest rate on long-term Government of Canada bonds. A project with one-third of its cost financed at 6% and two-thirds less the 25% of the loan to be forgiven financed at, let us say, 5½% would involve the municipality in annual costs for principal and interest of only $70,900 over a 20-year period. A reduction in annual payments from $87,180 to $70,900 is equivalent to a fall in the rate of interest from 6% to just over 3½%. Such sharp reductions in interest rates should stimulate municipal capital outlays somewhat, although delays caused by calling for construction tenders and meeting other loan conditions, the difficulty of moving work forward, and concern about overall municipal debt ratios may reduce its net impact on spending in the short-run.[31]

We received a suggestion that the federal government ought to supplement these various methods of borrowing assistance by making the interest on municipal bonds non-taxable for income tax purposes as in the United States. However, quite apart from the question of the subsidy involved, we have been informed that much of the benefit goes to tax-payers in higher brackets who find such bonds attractive. Although the federal treasury thus loses large amounts of revenue, there are not enough of such buyers to meet municipal needs, and many issues have to be priced at yields sufficiently high to attract holders less concerned with tax considerations. The result is an expensive, inequitable and inefficient method of subsidizing municipalities. In general, we believe that any borrowing assistance given municipalities by other governments should be compatible with ensuring the maximum sense of financial responsibility and a rational utilization of resources and credit.

It may be that the position of some smaller municipalities in the capital market would be slightly improved if they were allowed to issue sinking fund rather than serial bonds. The latter, because of their small annual instalments, often of uneven size and odd amounts, lack marketability and pose reinvestment problems for the individual investor, although in some areas significant retail purchases are made nonetheless. Sinking fund bonds of small municipalities would never be as highly marketable as those of larger issuers, especially since such bonds are usually bought for long-term investment by institutions and others, but they might assist in attracting some new buyers. Serial bonds are now manda-

[31] See *Financial Post*, comments of municipal finance officers, Sept. 28, 1963, page 27.

tory for all but a few large municipalities as a result of the mismanagement of sinking funds by some unsophisticated or unscrupulous municipal officers in the 1930's, but it might not prove impossible for regular annual payments to be made by municipalities to central sinking funds under provincial administration.[32]

In contrast to the United States market, there is as yet very little market in Canada for municipal or provincial issues with terms of over 25 years to maturity, most long-term issues being for about 20 years. Since some of the projects undertaken by these governments and their utilities have economic lives far longer than this, the provinces and municipalities might find it worthwhile to try to develop this market, especially in view of the growth of pension funds and others seeking very long-term investments.

While we have suggested that some minor modifications, mainly by the borrowers themselves, could usefully improve the market for provincial and municipal obligations in Canada, our general conclusion is that the financial position of the provinces is strong and that they have been able to raise funds from a widened variety of sources at favourable rates in relation to competing borrowers. At times when the demand for funds in Canada has been intense or credit policy restrictive they have had access to the United States market for a significant share of their requirements. Much the same is true of the larger municipalities. The increase in municipal debt ratios and the data on borrowing costs reviewed earlier do not suggest that there has been a general lack of availability of funds to municipalities, although a few governments—not always the smallest ones—have incurred some difficulties because of lack of market familiarity with them. We have suggested that much of this problem can be overcome, and have noted how various forms of provincial and federal government assistance have helped all municipalities to obtain additional funds on favourable terms.

[32] A wider market for serial issues might be created if registration facilities were improved. A possible first step would be a provincially-operated central depositary where bearer bonds might be exchanged for fully-registered deposit receipts.

CHAPTER 5

THE USE OF FOREIGN CAPITAL

Throughout Canada's history, non-residents have been important final lenders to her economy and have made a crucial contribution to her growth. Not only have they supplemented Canadian resources, they have helped to create new markets for our output and to raise the level of technical, management and other skills in Canada. In the years 1946-60, our net use of funds generated outside the economy—the counterpart of accumulated deficits on international current account transactions—was $8 billion, equivalent to almost 9% of gross Canadian capital formation during the period. Our use of foreign funds reached a peak of about 15% in the late 1950's —we had actually been suppliers of funds to the rest of the world right after the war—and has since been considerably reduced, the indicated figure for 1963 being around 5%.

Although most of Canada's financing in the post-war period has been generated within our own borders, the absolute amounts of foreign borrowing have been large. Our total gross liabilities to non-residents were $27.8 billion at the end of 1961 compared to $8 billion at the end of the war; after deducting Canadian capital invested abroad, our net liabilities have risen from $4 billion to almost $18 billion. As Chart 5-1 shows, these net liabilities were equivalent to just over one-third of G.N.P. in 1946 compared to about 48% in 1961. The increasing importance of direct investments[1] in the total, and their concentration in certain industries, has led to sharp increases in non-resident control of the manufacturing and resource sectors of the economy.[2] On the other hand, the share of outstanding Canadian bonded debt held by foreigners has been reduced from about 40% in 1935 to 16.5% in 1961. At the same time, net Canadian payments of interest and dividends to non-residents have declined in relation to a much enlarged national production: in 1962 they absorbed only about a third as much of Canadian output as they did in the later 1920's and were even smaller in relation to the payment burden of the 1930's.

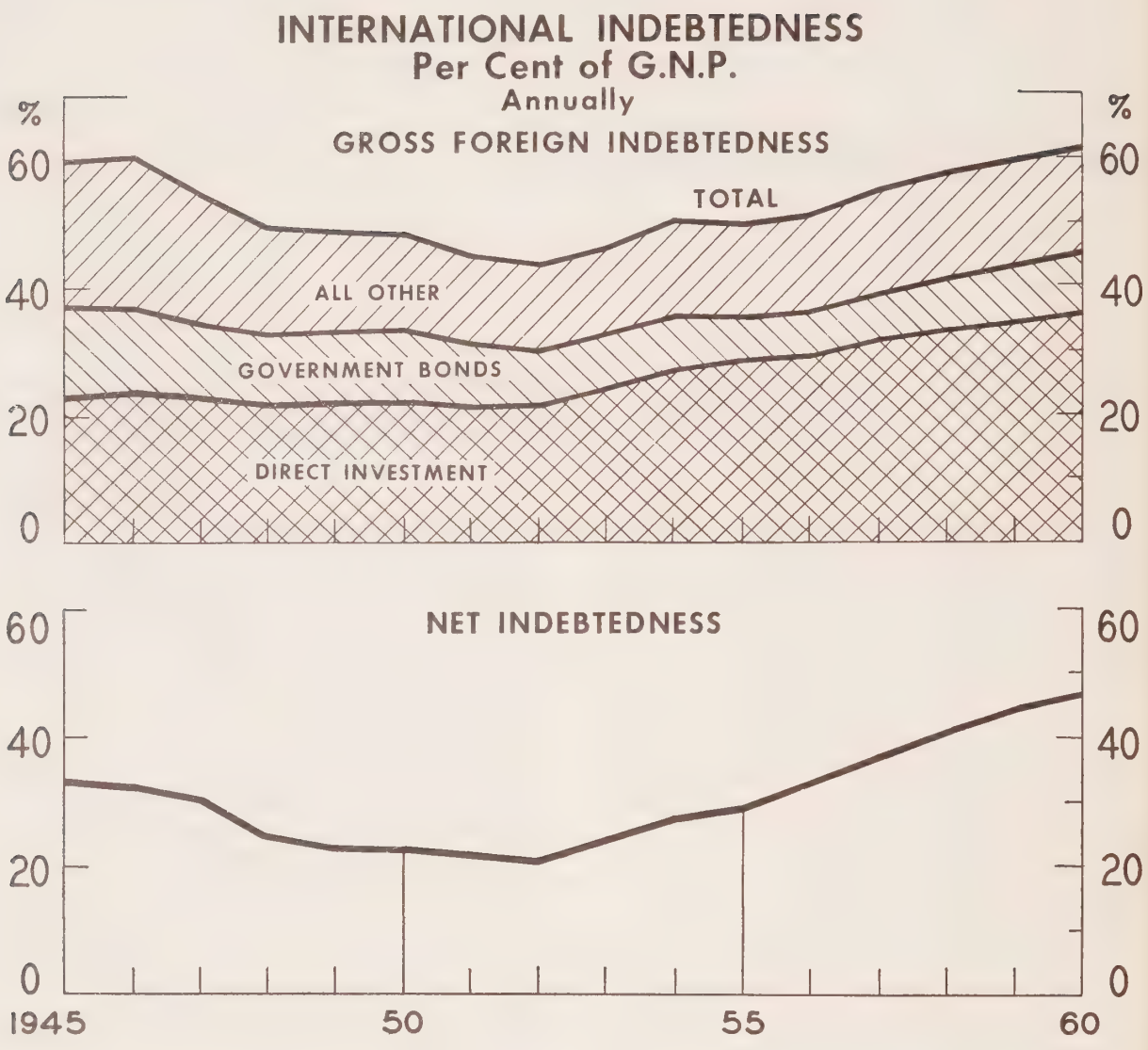
Table 5-1 shows clearly that direct investment has accounted for about two-thirds of the total post-war increase in our gross long-term indebtedness to non-residents. Government borrowing has been a relatively small proportion of the total except for a few years in the late 1950's, while the increase in foreign portfolio investments in general has been equal to under 15% of the increase in primary debt and publicly-available equities in Canada.[3] The increase in short-term commercial payables to non-residents on the other hand represents closer to 30% of the increase in recorded trade credit outstanding. Table 5-2, which shows an industrial distribution of direct investment in Canada, indicates that such direct investment has been heavily concentrated in the petroleum, natural gas, mining and smelting, and manufacturing industries. About three-quarters of

[1] See Footnote * to Table 5-1.

[2] However, as we point out later, the share of non-resident ownership of all Canadian industry is still somewhat lower than before the war.

[3] Trade credit is excluded from the computation.

Chart 5-1



this foreign investment is owned in the United States, the proportion owned in overseas countries having fallen from about 40% before the war; however, overseas investment has recently begun to increase in relative importance again with the renewed economic and financial strength of the main European countries.

It is worth emphasizing that the inflow of foreign capital in the post-war period is the third such major wave in this century—the others being in the railway and western development boom in the early 1900's and in the 1920's when foreign capital played an important part in the financing of the heavy investment in mining, pulp and paper, and manufacturing of that period. Foreign capital has, however, played a less important role in supplementing funds generated within Canada in post-war years than it did in the two previous

TABLE 5–1

CANADIAN BALANCE OF INTERNATIONAL INDEBTEDNESS

	1945	1949	1955	1959	1960	1961
	(Billions of dollars)					
A. LIABILITIES (foreign capital invested in Canada)						
Direct investments[a]	2.7	3.6	7.7	11.9	12.9	13.7
Government and municipal bonds	1.7	1.8	1.9	3.1	3.3	3.4
Other portfolio investments[b]	2.4	2.3	3.2	4.6	4.6	4.7
Miscellaneous long-term investments	0.3	0.3	0.6	1.3	1.4	1.7
Total non-resident long-term investment in Canada	7.1	8.0	13.5	20.8	22.2	23.6
Other investment, including short-term[c]	0.5	1.0	1.3	1.9	2.1	2.2
Sub-total	7.6	8.9	14.8	22.7	24.3	25.7
Short-term commercial payables	0.4	0.4	0.5	1.6	1.7	2.1
TOTAL GROSS LIABILITIES	8.0	9.3	15.3	24.3	26.1	27.8
B. ASSETS (Canadian capital invested abroad)						
Direct investments	0.7	0.9	1.7	2.3	2.5	2.6
Portfolio investments	0.6	0.6	1.0	1.1	1.3	1.5
Government of Canada loans, advances and subscriptions to I.M.F. and I.B R.D.	0.7	2.4	2.0	2.1	2.0	2.0
Total Canadian long-term investment abroad	2.0	4.0	4.7	5.5	5.8	6.1
Short-term assets abroad including official reserves	1.8	1.3	2.2	2.8	3.0	3.3
Sub-total	3.8	5.2	7.0	8.3	8.8	9.4
Short-term commercial receivables	0.1	0.2	0.3	0.5	0.5	0.5
TOTAL GROSS ASSETS	4.0	5.5	7.4	8.8	9.3	9.8
Canadian Net Liabilities	4.0	3.8	7.9	15.5	16.8	17.9

[a]Includes all concerns in Canada which are known to have 50% or more of their voting stock held in one country outside Canada and a few instances where it is known that effective control is held with less than 50% of the stock.

[b]Including income-accumulating investment funds.

[c]Includes Canadian short-term assets of International Monetary Fund and International Bank for Reconstruction and Development, Canadian dollar holdings of non-residents and equity of non-residents in Canadian assets abroad.

SOURCE: Dominion Bureau of Statistics. *The Canadian Balance of International Payments* which gives details of the basis of computation.

periods, and its composition and origins have changed dramatically.

In the first 14 years of this century, foreign investment of approximately $2.6 billion was largely British in origin, heavily in portfolio form, and directed mainly into the railway and government sectors. Direct investment by American manufacturing and resource industries was, however, beginning to make itself felt. The flow of foreign capital was subsequently greatly reduced by the onset of World War I and the surplus Canadian capacity which resulted from the extended investment boom. During the 1920's, in contrast, virtually all the net increase of $3.1 billion in foreign investment in Canada came from the United States, although over half of it was in portfolio form. This was the result of many factors, including the increasingly close commercial and social links between the two countries, the emergence of New York as the financial capital of the world, the growing ability of the American economy to generate surplus savings, and the desire of U.S. business to develop supplies of newsprint, minerals and other resources. Anxiety to take advantage of the preferential tariff for exporting to Common-

TABLE 5–2

FOREIGN DIRECT INVESTMENT IN CANADA

Direct Investment in Canada by Type of Business	1945	1955	1959	1960	1961
	(Millions of dollars)				
Manufacturing:					
Vegetable products	200	397	578	637	648
Animal products	47	91	119	122	135
Textiles	56	98	117	118	122
Wood and paper products	348	809	951	1,033	1,064
Iron and products	277	805[a]	1,345	1,441	1,504
Non-ferrous metals	211	624	977	983	1,020
Non-metallic minerals	43	122	198	240	249
Chemicals and allied products	144	431	637	671	741
Miscellaneous manufactures	33	57[a]	89	97	106
SUB-TOTAL (excluding petroleum refining)	1,359	3,434	5,011	5,342	5,589
Petroleum and natural gas (including pipelines)	138	1,754	3,082	3,313	3,534
Other mining and smelting	240	811	1,223	1,439	1,549
Utilities	375	320	282	285	289
Merchandising	202	538	761	757	804
Financial institutions	339	706	1,289	1,464	1,660
Other enterprises	60	165	258	272	312
TOTAL DIRECT INVESTMENT	2,713	7,728	11,906	12,872	13,737

[a]New series not strictly comparable with earlier years.
SOURCE: Dominion Bureau of Statistics. *The Canadian Balance of International Payments.*

wealth countries was also important in the growth of American-owned manufacturing establishments in this country. It was in this period that major non-resident control of our manufacturing and resource industries was obtained, a control that was undiminished in the 1930's despite a reduction in the amount of foreign investment stemming from the depression and its aftermath.

Despite these differences, all three periods have a number of important common characteristics. Business capital inflows occurred at times when Canadian investment programs were unusually large in relation to real output and savings, when the economy was running at capacity levels and when profit prospects were favourable. Thus, for example, the annual rate of capital inflow grew by over $1 billion to $1.6 billion from the first quarter of 1955 to the same quarter in 1957—a period in which business investment in Canada was expanding by no less than 60%. The flows on each occasion were also primarily oriented to the enterprises and industries giving impetus to the domestic boom, especially large and lumpy investments like the gas pipelines and large mining and private power projects in the late 1950's. This was particularly characteristic where projects depended on marketing or other contracts with foreign firms whose credit standing institutions in other capital markets could easily appraise. Moreover, most foreign funds typically went into new enterprises, although take-overs and financing of existing enterprises were also important. Finally, flows usually continued high after profit and capacity positions began to change fundamentally, with declines in response to weakening economic conditions being somewhat delayed. Thus, in the post-war period, direct foreign investment grew slowly up to 1949, accelerated gradually during the boom associated with the Korean war, reached a peak when the business investment program absorbed its peak share of G.N.P. in 1956-57, and has tapered off since, although the absolute amounts are still large.

The post-war wave of foreign investment was, of course, different from the others in that it was also influenced by American fears of critical supply shortages, particularly of strategic materials, and by favourable tax treatment in both countries. Moreover, current account deficits have persisted for rather longer after the boom reached its peak than was typical of earlier periods.

Long-term foreign portfolio investment, too, has typically been largest in periods of strain on Canadian resources and buoyant profit prospects, when foreign investors become enamoured of the "growth" prospects of Canadian equities. Indeed, because of this consideration, and favourable American tax treatment, a number of non-resident owned mutual funds were set up in 1954 primarily to invest in Canadian equities. Their holdings reached a peak of almost $400 million in 1958 and accounted for over a third of the increase in foreign holdings of Canadian equities in those years. The amount invested has since declined because of changes in the U.S. tax laws relating to capital gains and succession duties, the diminished attractiveness of Canadian stock markets and the appeal of investments in the overseas economies. Long-term debt flows naturally tend to be concentrated in periods of high economic activity as well, since their financial counterpart is relatively tight credit conditions in Canada. This in turn makes it attractive for Canadian borrowers to tap foreign markets and for non-resident investors to buy Canadian obligations. The continuance of unusually high inflows of portfolio capital from late 1957 to early 1960, at a time of relative slack in Canada, was in part the result of credit policies which led to inappropriate interest rate differentials between the two countries.

Chart 5-2 shows the differential between Canadian and American corporate interest rates since 1946, business capital outlays, and the annual change in non-resident holdings of corporate bonds and debentures. Foreign holdings of corporate securities showed their largest increase in the latter part of 1956 and in 1957 when Canadian business investment was at a peak and the interest differential was unusually wide. Much of this increase took the form of holdings of public utility and pipelines issues (earlier foreign flows had been mainly associated with the large resource industries), some of which were of a size or character which the Canadian market was unable or unwilling to handle. Chart 5-3 shows the same data for provincial and municipal government securities and the same parallelism between foreign portfolio purchases and high yield differentials and investment outlays. Foreign holdings of federal government securities have shown little change on balance in the post-war period, the main shifts being associated with issues and retirements of foreign currency securities by the federal government for national policy reasons to be discussed later. Apart from this, there was a general tendency for foreign holdings to decline in the early post-war years, especially when the government's financial position was strong, and to rise in 1958 and 1959 when both its cash requirements and the interest differentials between the two countries rose sharply.

While portfolio investment in long-term debt securities has been less important in the post-war surge of foreign investment than in earlier periods, it remains responsive to the same basic forces. Unusually high domestic demands for funds, especially when coupled with tight credit conditions in Canada relative to those in the United States, will normally lead to increased foreign holdings of Canadian bonds. Other factors are naturally important also—the willingness of issuers to incur foreign indebtedness, views about the future of the exchange rate, the timing of maturities, moral suasion from the federal authorities,[4] and tax measures on both sides of the border. We defer discussion of broad international policy matters until Chapter 23, but the fact remains that as long as Canadian borrowers have ready access to foreign markets, limits will be imposed on the range over which the Canadian authorities can vary domestic credit conditions without incurring exchange rate or reserve complications. This is true also of short-term foreign borrowings, par-

[4] This, as the experience of 1962 indicates, need not always be aimed at discouraging foreign borrowing.

CHANGES IN NON-RESIDENT BOND HOLDINGS AND RELATED FACTORS

Annually

Chart 5-2

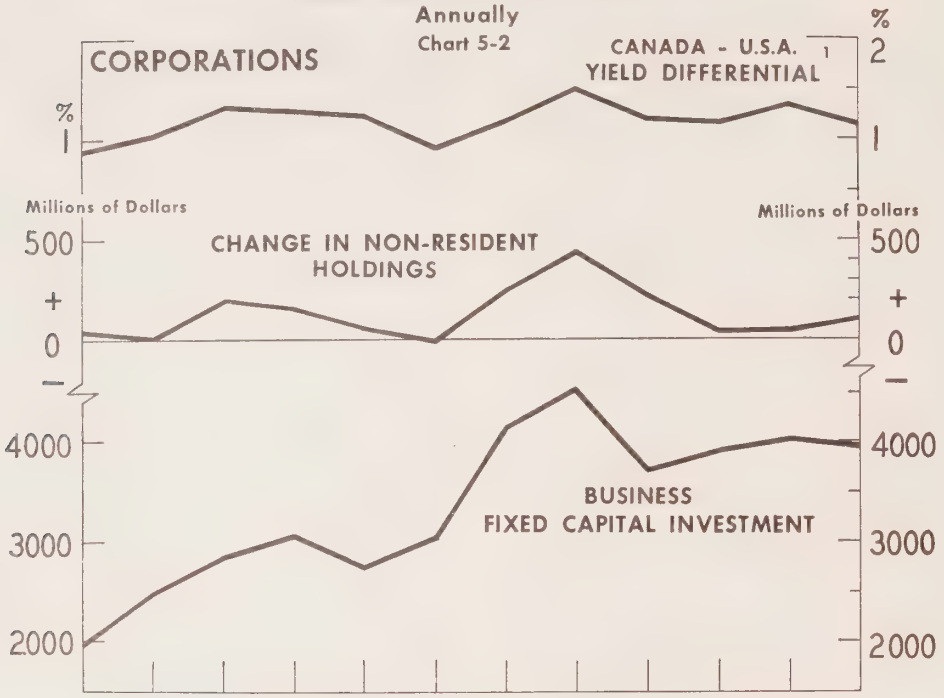
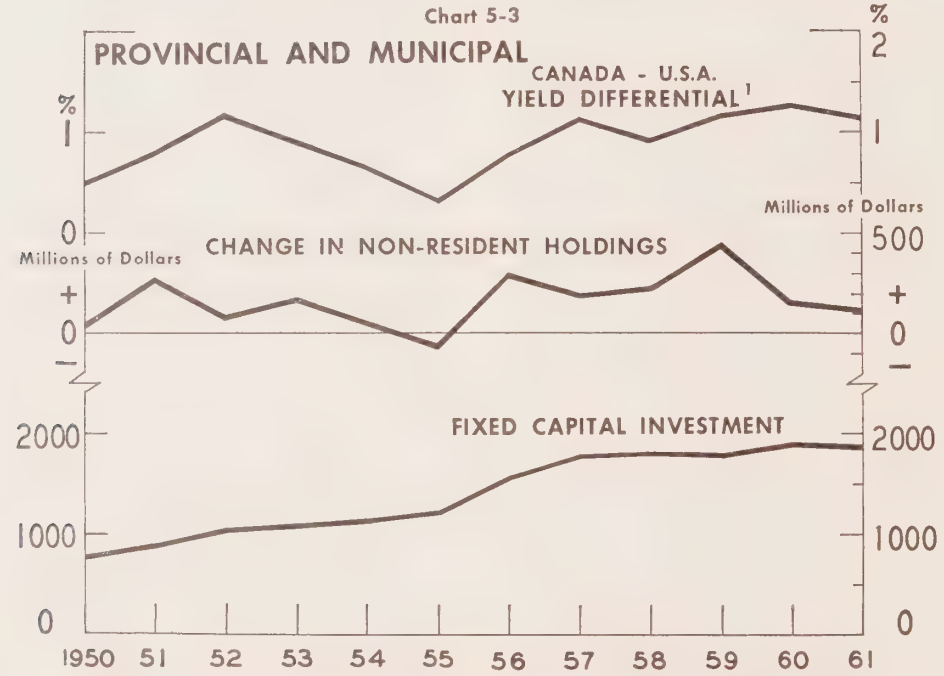


Chart 5-3



1. The yield differentials are those between the McLeod, Young, Weir industrial and provincial averages and Moody's Aaa corporate average.

ticularly on trade credit or open international account. However, in addition to being responsive to credit conditions in Canada, these borrowings are also affected by various official transactions, by speculation on the exchange rate, and by hedged short-term capital movements in international money markets to be discussed in Chapter 15.

THE RELATIONSHIP OF FOREIGN CAPITAL TO DOMESTIC ACTIVITY AND SAVINGS

At times of full employment and rapid growth in Canada, it is clear that net foreign capital inflows finance additional imports of real resources which enable the Canadian economy to realize a faster rate of growth than would otherwise be the case. The tendency for imports to rise faster than exports, and thus for the current account deficit to widen, in boom periods is clearly shown in Chart 5-4. It is not possible, however, to determine the precise relationship between capital inflows and domestic activity since one cannot be sure what would have happened if the capital inflows had not occurred. At one extreme, if domestic growth were largely the result of projects conceived and financed by non-residents which would not otherwise have taken place, the impact would be very large indeed. In more normal circumstances where Canadian expansion also had strong roots in purely domestic projects, foreign investment which brought new skills, markets and management techniques to our economy would still have important effects on national growth. At the other extreme, it is possible to imagine circumstances in which foreign investment would bring few of these advantages and in which its cessation at a time of full employment would lead merely to a fall in Canadian consumption and living standards with domestic investment remaining unchanged.

It is obviously very difficult to separate cause from effect in this as in other aspects of economic life. One can never be sure to what extent domestic forces govern the amount and composition of capital inflows and to what extent the inflows influence the size and shape of Canadian economic activity. Clearly, both forces are at work, although with varying strength at different times. Nevertheless, unless foreign investment is completely misconceived, it will normally flow in response to opportunities afforded by basic economic considerations and into lines of endeavour which reflect Canada's cost and resource advantages. As with domestic investment, however, some misjudgments or mistiming may occur which lead both to investments which are permanently or temporarily less profitable than expected and to some "bunching" of investment projects. This certainly occurred in the 1955-57 period and, along with excessive domestically-financed investments, contributed to the subsequent weakness in capital outlays and overall demand. Nevertheless, there can be no question that our long-run growth would have been slower without such foreign investment; short-run weaknesses in demand from 1949 to 1957 would probably also have been more intense.

It has sometimes been held that the continued —although reduced—foreign capital inflows in the years following 1957 when resources were unemployed in Canada constituted evidence of an unsound economic and financial structure, and in particular of an excessive level of domestic consumption and inadequate Canadian savings. A fuller discussion of this matter will be postponed until we discuss financial policy in the latter chapters of the report, but it is worth noting here how international capital flows will respond to domestic credit policy. If this policy is basically restrictive at a time of domestic slack, many Canadian borrowers will find domestic financial markets so tight that they will resort to foreign markets. This happened to some extent between 1958 and 1960, with net new foreign currency issues of provincial and municipal governments alone being some $550 million from mid-1958 to mid-1960. Despite some offsetting short capital movements, these flows tended to push the Canadian dollar to a higher level than would otherwise have been the case and to depress exports and encourage imports as a result: in short, the current account deficit was pushed upward in order

Chart 5-4

BALANCE OF PAYMENTS ON CURRENT ACCOUNT

NATIONAL ACCOUNTS BASIS
Seasonally Adjusted at Annual Rates
Quarterly - Billions of Dollars



to adjust to the high capital flows stemming from domestic credit policies. The effect was to reduce Canadian incomes and to lower Canadian savings to a level at which they, together with the savings being supplied by non-resident capital flows, balanced domestic capital formation. In such circumstances, the tighter was the domestic credit policy and the greater the inflow of foreign funds, the more likely were Canadian incomes and savings to be reduced.

We are not suggesting that a different credit policy would have solved Canada's problems of slow growth and current account deficits by 1960. Fundamental demand conditions had changed at home and abroad, Canadian business and labour had not yet adapted themselves fully to a more competitive environment, and there were inevitable delays in harvesting the full benefits of our increased capital stock in terms of displacing imports and increasing exports. Moreover, direct investment—some of it associated with takeovers of existing companies and thus not having direct employment effects in Canada—remained high in the 1958-60 period.[5] Nevertheless, we do not view the continuing current account deficits in the years after 1957 as being created primarily from unwanted foreign investment or from inadequate domestic savings. The high level of external borrowing after 1957 was not so much the cause of our difficulties as it was the symptom of the need for Canadian production patterns and financial policy to adjust to changing economic conditions.

SERVICING OUR EXTERNAL DEBT

As Chart 5-5 shows, the increased amounts of foreign capital invested in Canada have involved a substantial increase in net interest and dividend payments to non-residents. The annual average for the 1956-60 period of about $450 million, compares to an average of around $240 million in the late 1920's and in the 1930's.[6] However, partly because of this foreign investment, both merchandise exports and Gross National Product have grown faster than the servicing of our foreign obligations. The share of export proceeds and national output paid for the use of foreign funds is thus well below that of earlier periods, amounting to 8.9% and 1.3% respectively in 1956-60 compared to 20.4% and 4.2% respectively in 1926-30; the ratios were even higher in the 1930's.

Total dividends paid abroad accounted for only 45% of the gross interest and dividend payments to non-residents in 1926-30, but as a result of the increased importance of foreign equity investment, they accounted for 64% of the total in 1962. This increases the flexibility of our international payments obligations, especially in the event of a drastic fall in Canadian production which would almost certainly affect the profits of non-resident owned corporations as well. It also implies, however, that total payments will rise with production and profits. Nevertheless, even in 1962—when gross dividend payments abroad[7] had increased by over 40% from their 1955 levels to almost $500 million—net interest and dividend payments to non-residents of $570 million were equivalent to just under 9% of exports and to about 1.4% of national production.

QUESTIONS RAISED BY DIRECT INVESTMENT

As we indicated earlier, the large and fairly highly-concentrated direct investment flows of the post-war period have led to increased non-resident control of certain industries in the Canadian economy. Thus for example, non-resident control of manufacturing industries had risen to 59% in 1961 compared to 51% in 1954 and 35% in 1926; in mining and smelting the figures were 59%, 51% and 38% respectively.

[5] Such takeover flows will lead to an appreciation of the Canadian dollar under a floating exchange rate system if the authorities do not intervene. On the other hand, such flows should lead the authorities to ease credit conditions to offset their exchange rate effects. The impact of take-over bids on Canadian interest rates under a floating exchange rate is indeterminate. The bidder will have to persuade a holder of Canadian currency balances to part with them in exchange for foreign currency, while the bidder pays over Canadian currency in turn to the sellers of the company. Holdings of currency in Canada are unchanged, but the use to which they are put may be altered.

[6] 5-year averages have been used because of weakness of the annual data in the early period and to remove random fluctuations in later yearly figures.

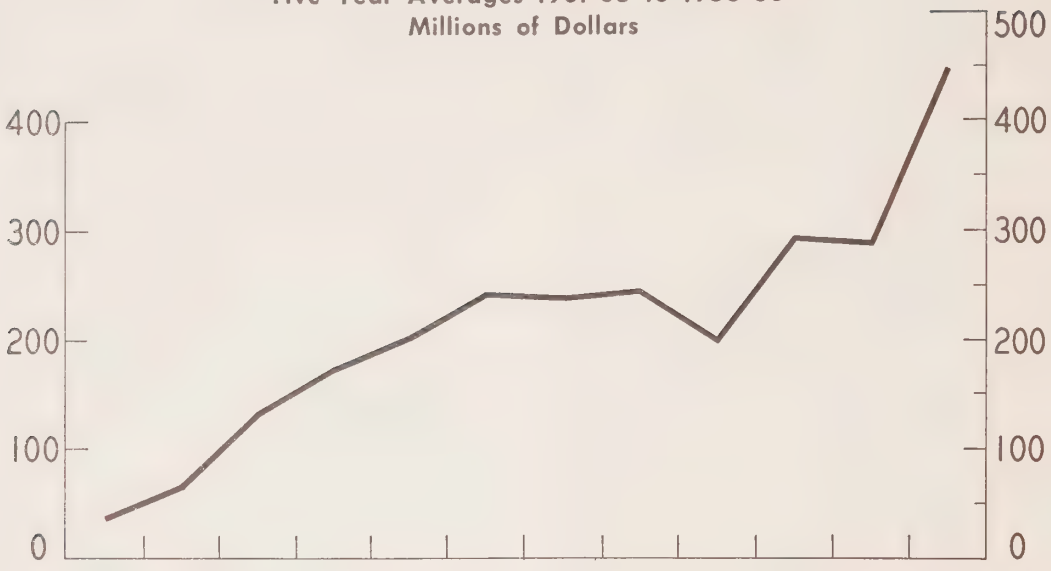
[7] Net of applicable withholding taxes.

Chart 5-5

NET INTEREST AND DIVIDEND PAYMENTS

Five Year Averages 1901-05 to 1956-60

Millions of Dollars



NET INTEREST AND DIVIDEND PAYMENTS IN RELATION TO EXPORTS AND GROSS NATIONAL PRODUCT

Five Year Averages - Per Cent



However, in petroleum and natural gas the control figure—at 69%—was unchanged from 1954 after being higher in the intervening years. Within manufacturing, there is a wide range of variation—from virtually complete non-resident control in the automobile and rubber industries to relatively minor influence in beverages, textiles and primary iron and steel where the 1959 figures were 13%, 23% and 23% respectively. In general, foreign ownership has risen less rapidly than foreign control, while in some sectors—notably utilities—both ownership and control have declined.[8]

This trend to increased non-resident control of certain of our major industries has given rise to a feeling of disquiet among many Canadians, in part because it is believed such control will tend to perpetuate itself because of earnings retained in Canada. In the 1946-60 period, undistributed earnings on foreign direct investments in Canada amounted to $4,150 million, compared to net capital inflows for direct investment of $5,090 million. If depreciation and depletion allowances generated in Canada by these firms are added, total retained cash after dividend payments amounted to $9.8 billion. As Table 5-3 shows, these internally generated funds were equal to 10.9% of gross domestic capital formation in Canada from 1946 to 1960, compared to 8.9% for net capital inflows of all kinds, some of which were in portfolio or other forms. Moreover, the percentage was higher in the last five-year period than in earlier years. If these internally-generated funds are regarded as an implicit transfer of capital to Canada by their owners, our reliance on foreign resources to finance gross domestic capital formation was somewhat more than double that shown by the deficit on our international current account alone.[9]

[8] See *Canadian Balance of International Payments op. cit.*, for details.

[9] See *Canadian Balance of International Payments* for details of the variety of possible ways to measure non-resident contributions to Canadian capital formation.

TABLE 5–3

USE OF FOREIGN RESOURCES IN RELATION TO DOMESTIC CAPITAL FORMATION, 1946–1960

	1946–1949	1950–1955	1956–1960	1946–1960
	(billions of dollars)			
Gross Domestic Capital Formation[a]	11.6	35.0	43.2	89.8
Use of Foreign Resources				
Current Account Deficit	−1.0[b]	2.3	6.7	8.0
Retained Earnings on Foreign Direct Investments in Canada	0.6	1.7	1.9	4.2
Other[c]	0.4	2.0	3.2	5.6
TOTAL FOREIGN RESOURCES	0.0	6.0	11.8	17.8
	(Percent of Gross Domestic Capital Formation)			
Current Account Deficit	−8.6	6.6	15.5	8.9
Retained Earnings on Foreign Direct Investments in Canada	5.2	4.8	4.4	4.7
Other	3.4	5.7	7.4	6.2
TOTAL FOREIGN RESOURCES	0.0	17.1	27.3	19.8

[a] Includes investments in housing and inventories.

[b] A minus sign indicates a surplus.

[c] Includes depreciation and depletion on foreign direct investments in Canada less retained earnings on Canadian direct investment abroad.

SOURCE: D.B.S. *The Canadian Balance of International Payments, 1960.*

While it is beyond our terms of reference to examine all the political and economic issues connected with non-resident ownership of Canadian industries, it should be pointed out that it brings with it important advantages which contribute to domestic employment and economic growth. Among them are the development of our resources, the establishment of new manufacturing enterprises and skills, and the creation of wider markets for our output. This is true also of many take-over bids, which often breathe new vitality into the company concerned. On the other hand, the view is expressed that some foreign-owned enterprises do not always give enough emphasis to the appointment of Canadians in top management positions, do not make a sufficient effort to purchase as many Canadian supplies as they economically could, are not allowed to compete in export markets[10] and may be less concerned with maintaining their Canadian operations than those in the home country.[11] Concern is also expressed about the amount of independent research carried out by such firms in Canada. These generalizations obviously do not apply to all foreign-controlled firms, many of which have completely Canadian management, extensive research facilities and are vigorously competitive in export markets; some of the others have costs too high to compete in foreign markets and are too small to support major research facilities.

Our purview is, however, confined to the financial implications and financial policy effects of foreign investment in Canada. As long as this investment is productive and adds to Canadian incomes and wealth, it will give rise neither to serious servicing costs in relation to Canadian earnings nor to misallocation of resources in the Canadian economy. On the contrary, it will accelerate our development and bring closer the day when this country will become on balance a net exporter of capital to other nations.[12] However, foreign legislation which provides an undue stimulus to foreign investment—or which puts barriers in its way—can lead to harmful repercussions on Canada, in the first case by encouraging relatively unstable and uneconomic investment and in the second by preventing otherwise soundly-based flows of funds. Equally, we do not look with favour on Canadian legislation which thwarts capital flows for reasons unrelated to our underlying economic need for them. If certain practices of either foreign or domestically-controlled enterprises are found to be harmful, we would prefer that any remedies be directed to the practices themselves and not to investment as such.

While it is not suggested that non-resident firms improperly influence our political life or attitudes, we find ourselves in sympathy with the view that more Canadian share-ownership and participation in the affairs of foreign-controlled subsidiaries might lead these companies to a greater awareness of Canadian attitudes and practices in their operations. At the same time, however, we recognize that the existence of a body of Canadian shareholders is not likely to lead to major changes in company policy. We are also conscious of the difficulties of all foreign-owned concerns offering a participation to Canadians. Table 5-4, based on a 1957 American survey, shows that 62% of U.S.-owned establishments in Canada were virtually wholly-owned, but many of these are small or unprofitable or cannot easily separate their operations from those of the parent company without setting up a conflict of interest between the two groups of share-

[10] A recent study suggests that American-owned firms in fact export more proportionately than Canadian-owned firms in the same industries—to all markets—and that foreign affiliation is a net inducement to export. See A. E. Safarian, *The Exports of American-Owned Enterprises in Canada*, paper delivered to the American Economic Association annual meeting, December 1963.

[11] A recent sample study by the National Industrial Conference Board showed that there was no significant difference in the charitable donations policies of non-resident and Canadian-controlled firms.

[12] As long as domestic capital formation in Canada is taking productive forms—which may include investment in schools and roads no less than in plant and equipment—it matters little at full employment levels whether Canada devotes more resources to the manufacture of investment goods and imports consumption goods, or vice versa. Through much of our history, there has in fact been a tendency for imports in boom times to take the form of consumer goods as well as machinery and equipment, with Canadian resources devoted relatively heavily to construction projects.

TABLE 5–4

VALUE OF U.S. DIRECT INVESTMENTS IN CANADA, 1957, BY DEGREE OF OWNERSHIP, AND PERIOD OF ESTABLISHMENT

(Percent Ownership)

Date Established	95% or more	50% to 95%	Less than 50%	Total	95% or more	50% to 95%	Less than 50%	Total
	(millions of dollars)				(percent)			
Before 1946	3,665	1,979	341	5,985	61.2	33.1	5.7	100
1946–1950	830	101	204	1,135	73.1	8.9	18.0	100
1951–1957	867	425	225	1,517	57.2	28.0	14.8	100
Total	5,362	2,505	770	8,637	62.1	29.0	8.9	100
of which:								
Branches	1,100				12.7			
Corporations	4,262				49.4			

SOURCE: U.S. Dept. of Commerce.

holders.[13] Moreover, there is evidence that at least in some cases shares offered to Canadians are in time sold to non-residents.[14] Nevertheless, we believe that more foreign-controlled companies could usefully offer shares to Canadians, while others could well follow the lead of some foreign companies and list the shares of the parent company on Canadian stock exchanges.[15] The Taxation Commission has the whole question of the tax treatment of foreign-owned companies under study, but we felt it within our competence to make a number of suggestions later in the report designed to encourage greater investment in equities by Canadian individuals and institutions. This, however, must be a gradual process since the absolute amounts of non-resident equity investment are so large. Canadians would require a considerable number of years to find the additional $2 to $3 billion of savings which the purchase of even a reasonable minority interest in existing wholly-owned non-resident-controlled firms would entail, quite apart from the foreign exchange question involved.

It is sometimes contended that direct-investment companies, by reason of their ready access to foreign funds, are more immune to domestic credit restraint than are Canadian-controlled concerns, a particularly important point given the large share of capital outlays made by such companies. However, in general we found that large firms, whether domestic or foreign-controlled, had easy access to foreign sources of funds. Firms in all size ranges also made increasing use of international trade credit in times of monetary restraint. Nevertheless, small, independent Canadian-owned firms appear to have more difficulty at all times in obtaining long-term finance than do those which are subsidiaries of large and well-financed Canadian or American corporations. The problem of the small firm was discussed in Chapter 3 but it is interesting to note that more than a third of Canadian-controlled firms with assets of under $1 million reporting to a Canadian Manufacturers' Association questionnaire reported sources of long-term capital as inadequate. This compared to 1 out of 29 non-resident firms

[13] See, for example, the views cited to the Montreal Stock Exchange by foreign-controlled companies asked to comment on the question of offering shares to Canadians, *Submission of Montreal Stock Exchange*, Appendix XII. Among the reasons given for not doing so were restrictions in the parent company's loan agreements and the lack of need for additional finance.

[14] *Op. cit.*, Table 14, and pp. 94-98.

[15] This practice is often followed by Canadian companies operating in the United States, and is helpful in cases where it is not possible to separate the operations in any one country from those of the world-wide operation.

in the same size category. The limited size of the sample and the lack of follow-up make it difficult to rely heavily on these results, but they do suggest that the small Canadian firm with no strong parent to fall back on encounters extra difficulties in long-term financing. This, however, is an argument for improving Canadian financing facilities for smaller firms rather than for discriminating against foreign-controlled companies.

The most important unfavourable implication of foreign capital in Canada's situation is that excessive dependence on external funds makes this country particularly vulnerable to developments abroad which might alter capital inflows and thereby limit our ability to pursue independent economic policies and stabilize the economy. Examples of the type of thing we have in mind are capricious changes in the sentiment of foreign investors and changes in foreign tax laws or financial policies such as the proposed American interest-equalization tax. Such measures, if carried out without regard to their repercussions on other countries, can have serious effects on nations such as Canada. While we will have more to say on the question of international financial co-operation in Chapter 23, we wish to record here our concern with the fact that the United States has felt it necessary to resort to such steps. At the same time, we must recognize that the major limit on our independence is the fact that we are a part of the world economy, and that the absence of a deficit on current account, or even the existence of a surplus, does not guarantee us against adverse developments in our financial position arising from events in other countries.

While the inflows of foreign capital in the postwar period have been large in total, particularly in the years between 1956 and 1960, there is now some tentative evidence that the flows will recede further in relative importance. Free flows of international capital in varying types and amounts will, however, continue to be necessary if Canada is to realize its full potential. This is not inconsistent with the aim of reaching a balance or even a net surplus, in our international accounts over an average of future years. Canadian rates of saving are high by most standards, and although there will continue to be high gross capital flows in both directions we see no inherent reason why large-scale net imports of foreign capital need occur when Canada has unused domestic resources. Adjustments to genuine changes in our economic circumstances cannot be expected to take place instantaneously, but if Canadian financial institutions and policy are performing effectively and our production costs remain competitive, we may reasonably anticipate a gradually-reduced reliance on foreign capital in future, with net imports of foreign capital being confined to years of abnormally heavy investment in Canada.

CHAPTER 6

THE FINANCIAL INSTITUTIONS AND MARKETS– A GENERAL VIEW

The primary borrowers and lenders we discussed in preceding chapters are the ultimate suppliers and users of all funds in the economy. The financial institutions and markets, on the other hand, are merely intermediaries[1] whose function it is to ease, and sometimes to encourage, the flow of credit from surplus to deficit units. Decisions to spend or to save are taken by those units, not by financial institutions and markets. Nevertheless, the financial institutions and markets play a vital role in the economic process; a sizable share of the nation's lending and borrowing goes through their hands and they thus have a significant influence over the allocation of resources and the efficiency with which they are used. Moreover, the institutions provide the economy with its payments system and are the main vehicle through which the policies of the authorities influence credit conditions. Their activities thus have an important bearing on the broader performance of the economy. It follows that good financial institutions and markets can and should reflect the fundamental preferences of the community and contribute to the achievement of an appropriate level and pattern of economic activity. However, they cannot by themselves assure us of growing markets and production, satisfactory employment and increasing efficiency. Nor can they create the real resources, skills and education, the qualities of enterprise and competitiveness and the desire to work, save and invest on which our standard of living must ultimately depend. These can only be developed by the decisions of many separate individuals and business enterprises and by the collective choice of the community as expressed in public policy. If as a nation our costs are too high, or we lack initiative, are short of trained personnel, or are unwilling to save enough to ensure our economic progress, a sound banking system and a highly developed network of other financial intermediaries will not solve our difficulties.

The financial intermediaries and markets deal almost entirely in financial assets and liabilities as opposed to physical goods and non-financial services, and this is what distinguishes them from other enterprises. The Bank of Canada, the government-owned central bank and monetary manager, is of course a financial intermediary, but because of its special functions its activities will for the most part be treated separately. The assets held by the various financial institutions other than the Bank of Canada differ widely in their nature, risk, and term—ranging from highly liquid, short-dated government treasury bills to risky, long-run investments in relatively untested businesses. Their liabilities also vary substantially, from chequable deposits redeemable on

[1] In many respects, of course, they are just like any other enterprise dealing in goods and services; to the extent that their own incomes from providing services exceed or fall short of their expenditures on goods and services they are net suppliers or users of funds; the magnitude of this activity is, however, small in relation to that of the economy generally, and will not be discussed further in this chapter. For example, physical investment of banks, insurance, trust and loan companies—most of which was financed internally—amounted to approximately $80 million in 1962, or under 1% of total private and public investment.

demand to long-term life insurance contracts payable many years hence. Yet despite these differences, and differences in the financial services they provide, these institutions share the common characteristic of being professional dealers in financial claims. Their assets are the debt instruments and equity shares of final borrowers or users of funds, and to a lesser extent of other intermediaries. These are financed by issuing their own liabilities, principally in the form of promises to pay of various kinds but also in the form of shares, which are held as assets by final lenders or suppliers of funds and, in minor amounts, by other financial institutions.

The participation of financial institutions in credit flows can be seen from Table 6–1, the upper half of which shows that at the end of 1961 non-financial units had total recorded debts of $66.8 billion outstanding. About $32.3 billion of these liabilities had been acquired by other non-financial units, including non-residents, while the remainder was held by Canadian financial institutions. In exchange for these instruments the institutions issued an equivalent amount of their liabilities in a variety of forms to suit the needs of the non-financial public, as shown in the second column in the bottom half of the table. The remaining liabilities of financial institutions were held by other financial institutions either as cash or investments. Of the total primary debt of $66.8 billion then, the non-financial public held just under half

TABLE 6–1

DISTRIBUTION OF PRINCIPAL DOMESTIC FINANCIAL CLAIMS[a]
(December 31, 1961, Billions of Dollars)

—	Liabilities of Non-Financial Units	Assets of Non-Financial Units	Financial Institutions	
			Assets	Liabilities
Debt of non-financial borrowers				
Government of Canada	18.6	9.3	9.3	—
Provinces	8.2	4.9	3.3	—
Municipalities	4.1	2.0	2.1	—
Business	13.1	4.0	9.1	—
Trade Debts[b]	5.4	5.4	—	—
Mortgage Debt[c]	12.4	5.6	6.9	—
Other Personal Debt	5.0	1.0	4.0	—
SUB TOTAL	66.8	32.3	34.6	—
Debt of financial institutions				
Currency and Demand Deposits	—	16.1	1.5	17.7
Other Deposits, Certificates, Notes, Debentures, etc.	—	3.5	0.9	4.4
Life Insurance	—	9.3	—	9.3
Pensions	—	4.1	—	4.1
General Insurance Companies	—	1.5	—	1.5
Balancing Item[d]	—	0.1	—	0.1
SUB TOTAL	—	34.6	2.4	37.0
TOTAL	66.8	66.8	37.0	37.0

[a]Excludes equities, and interpersonal debt.

[b]As in Table 1–1.

[c]Mortgage debt includes an estimate of personal holdings, as well as holdings by corporations, financial institutions and government agencies.

[d]This is the net amount of financial institution assets and liabilities not included elsewhere in the table. The principal items concerned are, on the asset side, equities, foreign items and premises and on the liability side, shareholders' equity and the current payables of some institutions.

directly and the remainder indirectly through the institutions. The assets of these non-financial units are equal to their liabilities, reflecting the fact that the financial wealth of one unit can only take the form of a claim on another, but the composition of those assets had been made more liquid, less risky, and more acceptable to these ultimate holders by the mediation of the institutions.

The intermediaries are able to play this role because there are important inconveniences to both final borrowers and ultimate lenders which limit the amounts and types of credit that can flow directly between them. Savers would have to expend considerable time and money to locate borrowers willing to offer them instruments of just the right terms, maturity, and amount for their individual needs. Despite these extra inconveniences and costs they would still incur additional risks from direct dealing as a result of their unfamiliarity with the borrowers, inadequate diversification of their portfolio of financial assets, the possibility of loss through changes in capital values or actual default, and the relatively great difficulty of disposing of some of these direct claims if they needed to do so. Moreover, the obligations issued by final borrowers do not provide all the services which lenders require of their financial assets, such as safe-keeping, life insurance protection or a convenient way of making payments. Similarly, final borrowers would have great difficulty in locating a scattered group of individual savers willing to meet their exact needs, familiar with their overall financial position, and possessing the ability to design a specialized borrowing instrument which made funds available to them under reasonable terms and conditions. Borrowers also need the specialized services which financial intermediaries can provide in the form of advice, location of those with available funds, trustee services and the like.

It is of course true that some of the economy's borrowing and lending does take place directly between individuals, businesses, governments, and non-residents. This is particularly the case when the borrower is especially well known to the lender, as when a firm extends trade credit to those with whom it has regular business dealings or when an individual makes a mortgage loan to a neighbour. Indeed, some non-financial units resemble the financial intermediaries in that they have extensive dealings in financial assets, obtaining the funds to extend this credit by issuing their own liabilities in the form of loans or securities. Most government and large corporate borrowers may also deal with final lenders through the financial markets in new or outstanding claims. The securities brokers and dealers provide a variety of agency and distributing services and play a leading role in bringing borrowers and lenders together, in keeping participants informed and sensitive to changing preferences, and in encouraging borrowers to make their obligations available in forms and denominations that are suitable to the portfolios of a wide range of investors. Yet no matter how efficient the markets and how much liquidity or saleability they add to such instruments as bonds, stocks and mortgages, they cannot meet all the needs of final lenders and borrowers. If financial institutions did not exist to take these claims into their balance sheets and to issue their own claims to final lenders in their place, much of the credit which now flows from lenders to borrowers in this way would only move at higher rates and under more restrictive conditions, while a good deal of it would probably not flow at all.

The financial institutions, being relatively well known to both those with funds to invest and those requiring them, are able to do business on a large scale, to acquire diversified portfolios of assets, and to develop specialized skills and efficient procedures for processing credit applications. This greatly reduces their own risks of loss and enables them to offer liabilities to savers in a variety of forms meeting their demand for diversification, safety, yield, liquidity, or prospect of capital gain. Savers will hold these claims for a lower yield than they would require on the underlying debt because these liabilities can be tailored more closely to their requirements, because risk is

reduced, and because related financial services are provided to them. At the same time, the skill and size of the institutions enable them to provide better service and lend at lower rates than the borrowers could get from direct lenders, while still earning a margin of profit for the institutions. In short, their activities facilitate the flow of funds from lenders to borrowers by reducing costs and improving liquidity, by increasing the number of routes over which credit may pass, and by enhancing the flexibility of the financial system.

The combined size of the financial institutions and the role they play in total credit flows will obviously be closely related to the size and complexity of the economy. The more complex and varied are the needs of savers and lenders, the larger their requirements and the greater the necessity for special skills to handle them, the bigger will tend to be the share of financial intermediaries in total financing. Their share of the business will also be increased by government policy designed to encourage or establish institutions, by their own efficiency and enterprise, and —most significantly—by changes in the structure of credit demand towards flows which can be handled more efficiently by them than by direct transactions between ultimate borrowers and lenders. Any one of these factors will increase the ability of the institutions to bid funds away from final savers by offering rates more attractive than final borrowers could manage in relation to the risks, costs, and inconvenience involved. Under these influences primary debt, the total debt issued by final borrowers, has tended to be held increasingly by the institutions.[2]

Some of the liabilities issued by financial institutions in the course of their business provide the economy with the means of making payments. These institutions, including the central bank, make available their own liabilities which members of the community will accept in settlement of debts and also provide an efficient mechanism for transferring these claims rapidly. In Canada the principal means of payment are coins issued by the mint, note and deposit liabilities of the Bank of Canada, and the deposit liabilities of banks and a number of other private financial institutions. Coins are legal tender in small amounts and Bank of Canada notes are legal tender in any amount —they must be accepted in final settlement of any debts. In practice, however, only a relatively small proportion of the dollar amount of the country's transactions is settled by actual transfers of currency because the public finds it safer and more convenient to use other financial assets. Obviously, assets in the form of long-term or risky institutional liabilities are normally unsuitable for this purpose but this is not the case with the deposits of financial institutions which are transferable on the customer's order or redeemable in cash at any time. Such deposits are part of the whole family of liabilities issued by financial institutions, serving as money because they are generally acceptable to the community in settlement of debts. Some, like bank deposits, are acceptable to virtually all Canadian residents, while others —like orders on local credit unions—may be generally acceptable only in a limited area.

Thus in Canada money takes the form of promises to pay on demand issued by a number of financial institutions: bank notes are a liability of the Bank of Canada and deposits are an obligation of the institution concerned. Money could indeed be any instrument or commodity which the community found safe and convenient to use in settlement of its transactions. Until comparatively modern times, it was in fact almost always a commodity such as shells, beaver pelts, or precious metals. However, regardless of whether or not money is a physical commodity or exchangeable into such a commodity—and this is no longer the case in Canada—it owes its existence as money primarily to the confidence of the community that it can always be quickly and easily used by the holder to obtain command over any good or service. Any asset which a creditor will accept in settlement of a debt serves as a means of payment for the purpose of that transaction, but the term

[2] Table 6-1 shows that the institutions held about 52% of all primary debt at the end of 1961. We have not constructed similar Tables for other years but the calculation shown at the bottom of Table 6-2, which overstates the institutions' shares because equities and claims on other institutions are included in their assets, indicates a more rapid growth of the institutions than of primary debt since the 1930's.

money is normally restricted to those assets which are acceptable as a means of payment to the community as a whole. Since some other assets have a limited acceptability as money any definition of the "money supply" is necessarily somewhat arbitrary. Moreover, the definition can never be an unchanging one, since institutional developments and collective decisions by the public may —as they have in the past—bring other assets into use as a generally accepted means of payment. Yet the fact remains that the liabilities of a group of private financial institutions are now the most common means of payment in Canada and that these institutions provide the payments mechanism essential to the efficient functioning of our modern economy. It is vitally important, therefore, that these institutions be fundamentally sound and that public confidence in their ability to meet their obligations be fully justified.

In responding to the financial needs of the community and in providing essential payments services, the institutions and markets influence both the allocation of real resources and the level of economic activity. Thus for example, if the markets and institutions are not sensitive to changing needs, newer lines of activity will find themselves unable to obtain adequate financing at reasonable rates, terms, and conditions in relation to the risks involved, while older enterprises will be favoured; the situation is similar if the markets and institutions discriminate regionally, or in other ways. If the net effect of such imperfections is to deter some productive activity that would otherwise have taken place, production and employment will be reduced in total as well as altered in composition. Moreover, if the institutions are inefficient, they will increase the costs, risks and inconvenience of saving and lending and absorb real resources which could be more profitably used elsewhere in the economy. In general, the more varied, skilled and creative are the institutions, the more likely are they to meet the needs of final borrowers and lenders, to encourage saving and investment, and to stimulate the real progress of the economy.

Yet the mere creation of new institutions will not raise total savings in the economy if there is already a sufficient variety of outlets, since it can only divert savings which would have gone to other uses. Nor will the extension of especially favourable terms to a particular class of borrower necessarily raise the total of national investment, although it may do so if previously unused resources are thereby productively employed: in any event other borrowers will pay relatively more for, or obtain relatively less of, the funds available than would have been the case in the absence of such preferential measures. In looking at the activities of financial institutions one must therefore bear in mind the fundamental difference between measures designed to encourage improved working of the financial system and attempts by one or other group to obtain more favourable treatment than objective considerations would dictate. There may be times when it is an appropriate aim of public policy to accord preferential treatment to some groups of borrowers or savers at the expense of others, but this is separate from the aim of encouraging the institutions to meet the needs of borrowers and lenders in an efficient and non-discriminatory way.

THE INSTITUTIONS AND FINANCIAL POLICY

The share of debt held by the institutions, in addition to being influenced by the longer-run factors mentioned earlier, is also influenced by the monetary and debt management policies pursued by the authorities. Each institution's share in total financial business is determined by the preferences of the public and by the willingness or ability of the institution to meet these preferences: it must offer its customers such liabilities in the form of deposits, debentures, or other obligations as they can be persuaded to hold as assets in their own portfolios. Like other units in the economy, an institution can extend credit only by giving up cash now in return for a claim on the borrower in the form of a loan or investment.[3] Put in another way, it extends current command over goods and services in exchange for what are in effect promises to repay,

[3] As we will indicate later, the form in which an institution holds its cash reserves does not affect this result.

in cash, the principal of the loan plus a margin of profit over expenses at some future date. It follows that an individual institution cannot increase its total portfolio unless it obtains more cash by inducing others to hold its liabilities; the same is true for the institutions collectively.

If the Bank of Canada alters the amount of ultimate cash in the financial system by increasing or decreasing the outstanding amount of its own note and deposit liabilities, the most liquid of all claims, it changes the amount of cash available to the institutions as a whole. As we will show later in the report, the central bank varies the amount of its own claims outstanding with the aim of affecting the cost, terms, and availability of credit and thus the amount of spending on real goods and services in the economy. While other techniques are also open to it and while it has other responsibilities, particularly to ensure that financial markets and the payments and credit mechanism work smoothly, this is its usual and most important means of influencing credit conditions. If it feels credit should be available on cheaper and easier terms, the central bank will seek to increase the amount of cash in the financial system. It will normally do so by purchasing government securities, paying for them by issuing a cheque on itself which after clearing and final settlement will be credited to the deposit account of the selling bank with the Bank of Canada. If the seller is not a bank, his bank will credit his account with the proceeds of the Bank of Canada cheque and forward it to the central bank for payment. In either event, the chartered banks' holding of ultimate cash has increased and no other financial institution's cash has decreased—there has been a net increase in the total cash in the economy.

This increase in cash will set in motion a chain of events, broadly but not precisely foreseeable, which will work through the financial system because the increased cash represents an unnecessary holding of a non-earning asset.[4] This will be the case whether the standard is the present requirement that banks hold Bank of Canada notes and deposits equal to at least 8% of their Canadian dollar deposits, or simply the banks' own view that cash holdings should be dictated by prudence and the need to meet cash drains in the ordinary course of business. Accordingly, the excess of cash will lead them to seek to expand their earning assets by adding to their loans and investments, paying for them initially by the issuance of additional deposit liabilities. This means that lending and borrowing through the intermediaries have increased, partly at the expense of direct transactions between final savers and borrowers. In the process the intermediaries will tend to bid up the prices of securities—which will already have tended to firm as a result of the Bank of Canada's initial purchase—to increase the availability of credit by relaxing the terms and conditions on which they make loans and investments, and to reduce the level of interest rates on financial assets generally compared to what they otherwise might have been. These lower interest rates on other financial assets will tend to have some effect on rates paid on their own deposit liabilities, both because their earnings on assets will be lower and because reduced rates will be sufficient to retain their share of deposit business and will still bring them all the cash they can profitably employ.

While any individual bank will find it loses cash when the customer from whom it purchases a security or to whom it lends money spends these proceeds, the banks as a whole will find that the extra cash remains with them since virtually all such funds—with the exception of some drain of currency into circulation—are re-deposited by the public or by other financial institutions somewhere in the banking system. Thus if the first bank finds its cash increased by $8 million by the initial Bank of Canada purchase from one of its customers and grants a loan of $7 million to a customer who spends it on additional supplies, the suppliers will re-deposit these funds in other banks which will in turn find themselves with extra cash with which to add to their assets. At this point, the banks as a group will find that their deposits have risen by $15 million

[4] Assuming that the public will not immediately remove the extra cash from the banks by increasing their holdings of currency—and such changes are not generally sharp or unpredictable.

—$8 million from the original security purchase and $7 million from the proceeds of the loan—but their cash has increased by $8 million. Since their cash ratio is still higher than it need be, this process of expansion will continue, only coming to a halt, all other things being equal, when the liabilities of the banking system have increased by $100 million. At this point the statutory cash ratio of 8% has been restored and any further expansion would bring the ratio below the requirement. Individual banks will share in this increase in cash reserves and total business in proportion to their success in attracting deposit customers in competition with the other banks. This is true whether they are all required to observe the same minimum cash reserve ratio or are free to hold differing reserves depending on their own preferences.[5]

If the central bank is withdrawing cash, the process is reversed, credit becomes more costly and less easily available, and banks will be obliged to liquidate assets and reduce their liabilities in order to maintain their cash positions. The less successful a bank is in persuading the public to hold its liabilities, the larger will be its share in the ensuing process of contraction.

The influence of the central bank over the financial institutions is not however limited to the chartered banks even though other organizations are not required to hold specified cash reserves at the Bank of Canada and in fact hold their reserves with the chartered banks. Assuming that no change has occurred in the public's demand for other forms of financial assets such as credit union or trust company deposits, these other financial institutions will also find their cash reserves increasing as the public deposits funds with them. The amount of these extra deposits will be determined by the share of new financial business which these other institutions are able to obtain. Thus if these non-bank institutions have one-third of this business, one-third of the increased bank deposits of the public will tend to find their way into their hands. They will then in turn be able to expand their loans and investments in exactly the same way as the banks. Moreover, these institutions will find that approximately one-third of the proceeds of the extra financial assets resulting from their own activities will be re-deposited with them. In the example given above, the end position will therefore be that bank deposits have increased $100 million and deposits and other liabilities of competing financial institutions have risen by $50 million.[6] In the course of this process, the ownership of some bank deposits shifted from the public to the other financial institutions as funds were deposited with them and back again to the public as these institutions made loans and investments. Assuming no other changes have occurred, the non-bank intermediaries will find their share in the enlarged business of the combined financial institutions unchanged and the proportion of chartered bank deposits held by them the same as it was before the expansion began.[7]

Like the operations of the banks, the increased activities of competing institutions will tend to bid up the price of securities, to increase the availability of credit, and to lower interest rates. If the relative demand for different types of credit is unchanged, these institutions will have to lower their lending rates in order to continue to obtain their share of the available business. Similarly, they will tend to lower their deposit and other liability rates if they are to maintain profit margins and to avoid attracting a higher proportion of cash from the public than they are for the time being able to invest profitably, given the fundamental factors which determine their share of financial business.

Whatever the underlying pattern of competition, the effect of central bank action spreads through the whole financial system because of the competition in financial markets and does

[5] However, the response of the financial system is more predictable if all banks work to known reserve requirements calculated in a uniform manner. A more detailed discussion of the points made in this and the following paragraphs will be found in an appendix to this chapter.

[6] In the first instance, $33⅓ million is deposited with non-banks who use the proceeds to purchase an equivalent amount of investments; one-third of this latter amount is re-deposited with the non-banks, and so on until a total increase of $50 million is reached. See the appendix to this chapter.

[7] We will discuss later the possibility of the non-bank deposit institutions varying their cash ratios.

not depend on all institutions holding their cash reserves with it. The central bank does not by itself interfere with this competitive process—the sharing of the resulting extra business will be determined by the institutions themselves and will depend on which are the most successful in responding to the continuing challenge of persuading the public to do business with them. The same is true when central bank policy induces a contraction in cash and rising rates spread through the institutions and markets: in the absence of a shift in the basic competitive situation, the institutions will find that they are losing cash unless they succeed in attracting and holding funds by increasing the rates paid on their own liabilities.

Indeed, the central bank would be able to exert this general pressure on the financial institutions and markets even if no reserve requirements were imposed on any financial institution, for it is the final source of cash for the whole system. Specific requirements, however, simplify the job of the central bank because they enable it to control directly the size of the main private issuers of liquid assets with reasonable precision. The exact effect of these Bank of Canada operations on each of the financial institutions cannot be accurately predicted since some institutions are slower than others to respond, all may work to slightly different cash ratios at different times (depending on the intensity of demand for loans and investments and their view of the outlook), cash may shift betwen institutions that work to somewhat different ratios, and market imperfections may slow or impede the transmission of cash through the system. Yet, as we show in the appendix to this chapter, the effects of such factors are relatively minor. They do not alter the main conclusion that if the institutions are able to compete for funds on reasonably equal terms, action by the central bank will affect them all, whatever their cash reserves and wherever they may be held, by affecting the terms on which they borrow and lend funds.

The injection of additional central bank cash will tend to increase the combined share of the financial institutions in the total credit granted in the economy. Since their expanded activities will result in lower interest rates and a greater availability of credit, ultimate borrowers have less need to seek credit from final lenders. The latter will thus be compelled to reduce their own lending rates for both direct transactions and dealings through the financial markets. Savers will consequently find that they have somewhat less incentive to buy direct debts since the differential interest return between such debt and the holding of money and the other more liquid liabilities of the institutions will have narrowed. The non-financial public's efforts to minimize its holdings of cash will therefore be relaxed and it will be content to hold the increased amount of more liquid institutional liabilities outstanding, thereby doing more of its lending through the intermediaries. Thus, for example, we find that the increase in the assets of all the main deposit-taking institutions was equal to over 40% of the increase in primary debt in 1960 compared to under 15% in the much tighter credit conditions of 1959. In 1955, a year of relative ease on the whole, the proportion was about the same as in 1960, while in 1956, a period of extreme tightness, the increase in the deposit-taking institutions was not much over 10% of the change in outstanding primary debt. These marked changes result more from variations in the growth of institutions than from changes in the growth of primary debt.

The central bank is interested in encouraging the institutions to convert the less liquid claims of final borrowers into their own more liquid claims (or in discouraging them from doing so) because this process influences the structure of liquidity, credit conditions and thus the level of spending on real goods and services in the economy. The liabilities of the financial intermediaries differ in many respects including their liquidity—the ease with which they may be transferred into the final means of payment with little or no risk of loss. Changes in the outstanding amount of those liabilities which are money—the generally accepted means of payment—exert a more powerful influence on conditions in financial markets, and thus on economic activity, than changes in holdings of other financial assets. Savers may hold

their wealth in any form—including money—but spenders must sooner or later have money to complete their transactions. Decisions to spend are not necessarily tied to immediate holdings of money, but if these and current earnings are insufficient to finance planned expenditures the spender must somehow obtain an acceptable means of payment if he is to meet his obligations. These additional funds can only come from final savers —either directly or through the financial institutions—in exchange for an increase in the borrower's liabilities or the sale by him of another asset. To the extent that financial conditions influence the spending decisions of the nation as a whole, therefore, they do so by affecting the cost and terms under which money is available in the economy generally.

Because they are known to be acceptable as a means of payment, money assets are a highly liquid form of holding savings and are thus normally the lowest-yielding in the spectrum of financial assets held by the public. Indeed, the most actively-used forms of money bear no interest and while interest is paid on some chequable deposits—either explicitly or in the form of free services—the rates are generally low relative to those on other assets. If as a result of the expansion of the intermediaries, the supply of money[8] is growing more rapidly than the supply of other financial assets, there must be an adjustment in the relative returns on money and other assets in order to induce the community to hold an increasing share of its wealth in this highly liquid form. If public preferences have not changed this can only happen if money has become more attractive relative to other assets—a process which as we have seen normally involves lowering their rates of return rather than increasing that of money. As the institutions issuing more liquid claims expand their portfolios and as the public which comes into possession of the increased supply of money attempts to readjust its own holdings of financial assets, the yields on those assets fall and credit conditions ease in a way which would not be true of increases in the share of wealth held in less liquid forms—for instance in bonds, stocks, or pension claims.

In general, the shorter the term and the closer to money are the liabilities issued by the institutions and final borrowers, the less impaired will lenders of funds feel their position to be, the more they will regard these assets as readily shiftable into money if necessary, and the greater will be their willingness to run down their holdings of money itself. While it makes relatively little difference to a borrower whether he obtains funds from an institution dealing in short-term deposits on the other side of its balance sheet or borrows on similar terms from some other source, the fact that the counterpart to the former loan is a highly liquid asset held by final lenders will lead to easier credit conditions than if the counterpart were some less liquid asset.[9] However, borrowers are affected by the length of the term for which funds are formally available to them. They will feel more liquid if they sell long-term obligations than if they obtain funds through bank loans payable on demand or through the sale of short-term money market paper, even though the former may never be called and the latter can usually be re-financed. This feeling of impairment of liquidity may lessen as they and others gain experience of short-term market financing, although views on what proportion of liabilities may be incurred in short-term form will also be affected by economic conditions. Since these effects on borrowers' liquidity are less important than the liquidity consequences for lenders of differing structures of asset holdings, an expansion of the activities of institutions and markets which results in the issue of more liquid claims will result in lower interest rates and easier credit availability than would have been the case if the same amount of financing had taken place through the issue of longer-term or less liquid obligations. The more liquid is any given amount of outstanding financial claims in the hands of final

[8] Strictly speaking, the supply of money not needed for current spending transactions.

[9] To be precise, this distinction cannot be drawn merely between institutions—the public's liquidity will be considerably less enhanced if the counterpart of, say, a bank loan is a six-year term note than if it is a demand deposit.

savers, the easier will be credit conditions. Yet whatever the initial position, the effect of the central bank's operations on the institutions' activities gives it the power to encourage or discourage the manufacture of liquidity and thus to influence the terms and conditions on which the economy as a whole can obtain money to finance its spending.[10]

Although the precise effect on credit conditions of an expansion of the institutions' combined assets and liabilities cannot be accurately forecast, it will tend to result in an increase in the public's holdings of money and near-money assets and cause a relative easing of interest rates and the availability of credit to borrowers.[11] Assuming that the demand for credit has remained unchanged, the amount and speed of the easing in credit conditions will depend on the behaviour of the institutions and on the reactions and expectations of the public and of the markets in direct claims. The object of encouraging the substitution of the more liquid claims of the institutions for direct debt in the portfolios of savers in these circumstances is to encourage spending on real goods and services. The fall in interest rates and easing of other conditions under which credit is extended makes it cheaper and easier for individuals, business, or government to borrow to finance expenditures. It also makes it less attractive for final savers to hold or accumulate financial assets compared to investing in real assets or to spending generally.

If borrowers previously unable to obtain or afford funds at the higher cost then prevailing now find it possible and economic to incur debt in order to proceed with expenditures, extra income and employment will be generated. The same is true if those who had previously planned to save now decide to spend instead. The easing of credit conditions will not, however, generate additional spending by itself unless spenders have investment projects or plans for consumer outlays that had been held back by the cost and unavailability of funds.[12] Nor will it make it possible for any unit to undertake extra expenditures by borrowing if its fundamental difficulty is that the project is unsound or its financial position is too weak to support additional debt. To the extent that spending is stimulated and extra investment or less saving does take place, however, a chain of incomes will be generated whose extension will come to a halt when a new balance between saving and investment has been reached. In the absence of other changes, the greater is the tendency to save out of the extra income and the less this rate of saving is reduced by the new lower interest rates, the lower will be the level of incomes at which this balance is achieved. The initial fall in interest rates will be modified by the expansion in incomes since some of the extra money resulting from central bank encouragement of the institutions will be needed to transact the new higher level of expenditures in the economy. To the extent that this "feed-back effect" modifies spending plans, it also will contribute to damping down the cumulative expansion in incomes.

The ability of the financial institutions and markets to transmit funds from final savers to borrowers is by no means affected only by central bank action. As we indicated earlier, it is also affected importantly by the level and structure of the demand for credit. If the demand rises relative to the supply, say because the central bank is not allowing the cash base to increase in the face of rising borrower demand for credit, all institutions will find that they can obtain higher rates on their loans and investments. Although the banks will be unable to expand their total assets and liabilities because of the limitation on their cash, the other financial institutions will try to persuade the public to transfer their bank deposits to them by offering them a higher return on their funds. Earnings of these institutions will be increased if they can obtain these funds at rates which allow profitable re-lending at the new higher interest rates to their own customers and to applicants refused

[10] Bank of Canada, Submission II, paragraph 57.

[11] This would not be the case if at the same time the public's desire to hold wealth in liquid form had risen by an offsetting amount; indeed, if this change in liquidity preference had been sufficiently pronounced, interest rates might even have risen.

[12] The effect of changing credit conditions on expenditures is discussed in Chapter 21.

at banks. If they are successful in meeting these increased demands for funds, they will improve their share of the financial business and expand the flows of credit in the economy even though the supply of ultimate cash has not changed. The banks can, however, prevent this from happening by raising the rates on their own liabilities to the point where other institutions do not find it profitable to bid for extra funds. The banks may not be willing to do this, in which case their relative loss of position will reflect their own competitive attitude. They may also be unable to do so because there are legal restrictions—on either the assets in which they may invest or on the rates they may charge—which limit their ability to bid for deposits. Both factors have been at work in recent years.

Even in the absence of legal restrictions on the ability of banks or others to compete for funds, the competitive process we have described would be only approximate. In fact, the preferances of final borrowers and lenders and the other factors affecting the basic competitive position of different institutions are constantly changing with the shifting pattern of the economy. This may be due to a change in the relative intensity of demand for credit of different types within a given total—for example, a rise in demand for mortgage loans offset by a fall in the need for other credit will enable mortgage lending institutions to raise their rates and attract funds away from other lenders who will be faced with lower earnings and a smaller demand for funds. Some institutions may also be able to increase their share of the financial business by being more willing than competing institutions to bid for funds: for example, when the demand for credit is high some institutions put more emphasis than others on raising their rates on funds and rather less stress on rationing credit. Those who do the reverse will suffer a relative reduction in business, just as they will if they are unwilling to reduce lending rates when credit demand eases; in the latter situation they will lose lending business to competitors and will thus find fewer profitable outlets for their funds. Changes in public preferences for a particular type of financial assets may also enable some intermediaries to lower their rates on liabilities compared to the average going rate on close substitutes and thus improve their competitive position. Finally, some institutions may improve their efficiency, enabling them to operate on finer gross profit margins than their competitors who will tend to lose ground.

In addition to these longer-run changes, there may be shorter-term shifts in competitive position at different points in the business cycle even though this is not the case over the cycle as a whole. Thus when credit demand and interest rates are low, the institutions offering comparatively low-yielding money and near-money liabilities may find it relatively easier to expand their assets profitably; in the reverse situation, institutions dealing with borrowers who are prepared to pay very high rates to obtain credit will find that the high returns they can earn on these extra assets enhance their ability to compete successfully for funds. Moreover, not all institutions, savers, and borrowers will respond in identical ways and with the same speed to changed financial conditions, although the holders of broadly similar liabilities in different institutions do not seem to differ widely in their sensitivity to changing credit conditions. Despite these shifts in competitive position which are continually taking place, all institutions nevertheless find that the terms on which they do business are influenced by Bank of Canada action and that the nature of their response will affect their position. However, the business of some of the institutions dealing largely in longer-run claims is affected more by changes in income levels and fundamental savings habits and is not especially sensitive to price factors, particularly at the short end of the market.

A policy of restraint will thus spread out through financial markets in the same way as a policy of ease. Since the institutions are unable to expand their assets and liabilities as much as they otherwise would, borrowers will tend to turn increasingly to direct lenders for funds. At the same time, savers will have an additional incentive to economize on money and near-money assets because of the attractive returns available from direct lending. Money will be tempted out of unusual places, in the sense that balances nor-

mally idle will be spent or invested by their holders, and the share of financial institutions in total credit flows will tend to drop. Thus we find in such circumstances that direct debt in the form of increased trade credit and public holdings of securities and mortgages rises sharply as a percentage of all credit extended. Moreover, since the demand for funds has risen relative to the supply, the institutions may find it increasingly difficult to obtain funds on terms which ensure their profitable use. Rising interest rates will therefore tend to bring about an economy in the use of cash, and the existing stock of money will turn over faster—both absolutely and in relation to income. The financial institutions play an important part in this process of altering the velocity of money by selling some of their existing holdings of financial assets—especially more marketable government bonds—to non-financial holders of inactive money and by lending the cash thus obtained to spenders who put it into active circulation.

The process will eventually come to a halt either when institutions and the public find the costs and inconvenience of running down their liquidity position excessive and cease to make funds available or when the rise in interest rates curtails the borrowers' demand for funds. The more willing are lenders to part with funds as rates rise and the less deterred are borrowers by these higher costs, the greater will be the velocity increase. Short-run changes in the velocity of money are thus usually a reflection of the reaction of savers and borrowers to changing credit conditions and are not a separate factor which in some way "off-sets" the attempts of the authorities to ease or tighten the financial system. In the absence of a hyper-inflation in which the public attempts to get rid of money as fast as it can, there is usually a reasonable limit to the increase in the ratio of income to money that is likely to take place, although this tendency to economize on cash does impart considerable "stretch" to the financial system over the range in which credit conditions are likely to move. This elasticity in the financial system, while tending initially to blunt the effects of monetary restraint on real spending, is at the same time a reflection of the spread of that restraint through the economy as a whole and does not mean that the policy is thereby made ineffective. The effects of this restraining policy will, of course, depend on the extent to which spending that otherwise would have taken place is deterred by the extra cost and difficulty of borrowing and by the extra inducement to acquire and hold financial assets rather than spend on real goods and services. This relatively reduced spending will cause further indirect reductions in expenditures by lowering the level of income and reducing the pressure of demand on real resources in the economy from what they would have been in the absence of restraint.

The financial institutions at all times play a central role in the flow of funds from final lenders to borrowers and hence influence the allocation of the nation's real resources. If it is made easier or more difficult for them to change the form of the relatively illiquid claims issued by non-financial units into safer, more convenient and more liquid assets—and especially into money or near-money—the cost, terms and availability of credit in the economy will be affected. These altered credit conditions in turn exert an effect on real spending, which explains why the central bank has an interest in stimulating or restraining the activities of the institutions. While especially concerned with those institutions issuing claims at the more liquid end of the spectrum because of their particular influence on credit conditions, and thus on spending, the central bank's actions will not by themselves affect the more fundamental factors determining the competitive position of each institution within the total.

We have discussed the impact of Bank of Canada operations on the institutions largely in quantitative terms, but we do not want to leave the impression that the central bank operates according to some mechanical formula related only to the size of the intermediaries or the amount of money or money-substitutes in existence. Quantities and prices are inextricably related in the processes described, and the Bank's actions are taken with a view to affecting both

in order to exert the appropriate influence on credit conditions and thus the economy generally. Moreover, the precise outcome of any given Bank action will depend on all the forces at work in financial markets, not just its own operations. In the normal course, as its Submission makes clear, the Bank decides whether to reinforce or offset pressures arising from changes elsewhere in the economy, and in arriving at such decisions it takes into account fundamental economic trends and broader financial and interest rate developments rather than focussing on the money supply and the intensity with which it is used. Indeed, as we shall point out later, there may be times when changing the structure of the government's debt in the hands of the public rather than operations on the cash base will bring about the desired change in the prices and terms on which the institutions and other economic units extend credit.

THE BORROWING AND LENDING ACTIVITIES OF THE INSTITUTIONS

Regardless of whether the central bank is discouraging or encouraging their expansion, we have shown that the intermediaries are always in competition with each other as borrowers trying to sell their liabilities to purchasers of financial assets. They also compete as lenders seeking to find profitable outlets for their borrowed funds in the form of attractive earning assets. Finally, they compete in the provision of a variety of other financial services, ranging from safekeeping facilities all the way to the management of customers' financial affairs. While the goodwill and earnings from these services are important, most of the earnings of the institutions usually come from the margin between the revenue on their assets and the costs of obtaining and keeping the necessary funds. This competition may be efficient or wasteful, takes many forms in different parts of the market, is weak in some areas and strong in others, and is based sometimes on prices and sometimes on other factors. It does, however, have the underlying common characteristic that each institution is trying to persuade both borrowers and lenders to do business with it. Since the institutions can only invest in earning assets by being prepared to give up cash, they cannot expand unless they succeed in convincing the public to hold more of their liabilities. At the same time, these funds must be invested wisely and profitably; only by inducing credit-worthy borrowers to deal with them can the institutions earn the income necessary to pay the cost of borrowing, cover their other expenses and leave themselves a reasonable margin of profit.

Competition for funds by the sale of liabilities is as important to a bank as to an institution whose liabilities do not serve as money. This point may be brought out by a brief examination of the way a financial institution lends or invests. If an institution's own liabilities are not an accepted means of payment, it must be prepared like any other lender to give the borrowers cash, which for it may be either currency or demand deposits at some other institution. At the end of the transaction the institution will not be any larger: it will merely have altered the structure of its assets, exchanging cash for a claim on the borrower. It is clear that institutions of this sort can expand only if they succeed in selling more liabilities in exchange for cash and use this new cash to acquire earning assets. If the lender is a bank, whose own deposit liabilities are money and therefore acceptable to the customer as a means of payment, it may initially grant a loan or buy an asset by crediting the customer's account. At this stage the bank will have expanded without actually losing any cash, although the ratio of its cash holdings to total liabilities will have declined. However, this is not the end of the transaction for it is very probable that the customer wanted money not to hold but to spend on some real or financial asset. As he draws on his deposit account most, if not all, of these payments will be made to customers of other deposit institutions and the bank will therefore lose cash reserves—which for a bank are currency and deposits at the Bank of Canada. The bank, like any other institution, has acquired an earning asset at the cost of losing another asset, cash reserves, while the accompanying reduction in its deposits leaves its liabili-

ties the same as they were before. Indeed, any institution can if it chooses temporarily expand by opening an account on its books in settlement for a new loan or investment, but whether or not it is a bank it will sooner or later have to give up cash and revert to its previous size, although with a changed portfolio of assets.

The conditions which apply to an institution issuing money claims are thus fundamentally the same as those under which other institutions operate, even though the cash for which the former competes may be currency and deposits at the central bank rather than currency and the deposits of other institutions. No institution can expand its size unless it competes successfully in the business of persuading the public to give it more cash in exchange for holding more of the institution's liabilities. It follows that the distinction sometimes made between institutions described as channels through which funds pass from the lenders to borrowers and institutions which "create credit" is misleading. Any individual or enterprise in the economy, financial or non-financial, can extend credit by giving up cash to the borrower, but a bank with an 8% cash ratio can no more expand its assets 12½ times when it initially receives a dollar of cash than can a trust company or business firm working to the same ratio.

Of course, all financial institutions, like virtually any other economic unit, keep only a fraction of their assets in cash to meet possible claims against them by their customers and other institutions: their business is to pass this cash on from savers who do not for the time being need it to borrowers who do. To the extent that there is excess cash in the whole financial system—for whatever reason—and this cash is re-deposited with other institutions, the cumulative process of expansion described earlier will take place until all the institutions have restored their ratio of cash to other financial assets to the desired level. As we emphasized, however, *all* institutions—not just banks—share in this process. Their share will be determined by the proportion of the financial business they are able to attract by exchanging their own liabilities with the public in return for cash. The adjustment may be slower for institutions issuing very long-term liabilities, like life insurance companies and pension funds, since their claims are not close substitutes for liquid assets and the growth of their business is more closely related to the growth in incomes. However, the public's re-arrangement of their financial portfolios will also affect them, although perhaps with less force than it affects institutions dealing in more liquid assets. Regardless of the type of liability issued, broadly similar institutions will be affected in similar ways. A bank attracting 5% of the total short-term deposit business would thus be able to expand no more and no less than a trust company or caisse populaire attracting an identical share of the total. Each will find this proportion of the entire deposits in the system flowing back to it, in the absence of competitive changes, and each will therefore find itself with excess cash with which to expand its loans and investments until its cash ratio is restored to working levels.

In stressing this similarity between banks and others in the competition for cash and the conduct of financial business, we do not wish to imply that there is no meaningful difference between money and near-money assets and other financial claims. We do, however, wish to point out that the former are not "created" in any mysteriously different way, even though they do influence financial markets and spending decisions with particular force. An expansion in lending by banking institutions is no different in principle from increased lending by other intermediaries, or indeed non-financial units, although the resulting increase in the public's money balances or other highly liquid assets will lead to easier conditions in financial markets than will an equivalent expansion in public holdings of, say, life insurance policies—the counterpart to life insurance lending.

The foregoing discussion has touched on the fact that each of the financial institutions specializes to some degree: they do not all issue the same liabilities, invest in the same assets or provide the same services. On the borrowing side, their liabilities differ very substantially in the

services and returns which they offer. The chequable deposit liabilities which banks and some other institutions issue provide their holders with a highly liquid asset and a convenient means of making payments, although the savings deposits of banks are in some respects more akin to the non-chequable time deposits issued by other institutions in that some of their holders do not in fact use them as a means of payment. Other claims issued by institutions are less liquid than these money balances—none of them is transferable by cheque and they may normally be redeemed only after notice or at some specific time in the future. Since these non-money claims do not give the holder the same convenience and flexibility in managing his affairs, he must normally be offered some other inducement to hold them. This may take the form of a higher rate of interest as is the case with bank deposit receipts, trust company investment certificates, loan company debentures and the notes issued by sales finance companies; the rate of interest is normally higher the longer the period for which funds are committed and the less easily shiftable is the instrument. In the case of other institutional liabilities like mutual fund shares, the inducement may be in the form of dividends or prospects of capital gain. Still others, like life insurance and pension contracts, offer a guarantee of future benefits.

These examples only suggest the broad range of liabilities which the financial institutions issue to do particular jobs in the public's portfolios of financial assets. Since the needs of different individuals and firms differ in many ways, the institutions are not all competing in the same markets for the same sort of funds. Banks draw funds from a wider range of customers than other institutions because virtually every unit in the economy needs money balances and a reserve of highly liquid assets in order to carry out its business easily and efficiently. Short-term interest-bearing claims appeal to a more limited range of individuals and firms whose resources are large enough to include financial assets in excess of this basic minimum of money balances. In many cases these instruments are specifically tailored to meet the customers' particular investment plans. Finally, life insurance policies are designed primarily to provide protection to individuals rather than businesses and most policies are sold to them, although the recent growth of group insurance and pension policies covering business employees shows how the nature of the public served by the institutions can alter with changing circumstances. The character of each institution, the number and location of its offices and the way in which it is organized and administered are strongly influenced by the nature of the market in which it borrows its funds.

On the asset side of their business, institutions also tend to specialize. Again the chartered banks deal with a wider range of borrowing customers and in a broader range of markets than other institutions; they lend to consumers, to business firms, to governments and, indeed, to other financial institutions. Within this broad range they have, however, given particular emphasis to short-term lending. Other institutions, like the small loan companies who lend exclusively to a relatively limited range of individuals for comparatively short periods, have tended to specialize more narrowly. Sales finance companies also concentrate on consumer lending, although they have recently devoted an increasing share of their resources to business and mortgage lending. Some institutions lend only to business firms, and within this group some specialize further on financing new and small companies. Trust, loan and insurance companies are particularly interested in lending in the mortgage markets. Other institutions like the credit unions also tend to specialize in particular types of lending.

A number of factors influence the choices made by institutions about the emphasis in their business. First of all, they feel that the type of asset they hold and the maturity structure of their investments should be related to the type of liability they issue. For instance the banks' preference for short-term lending reflects the fact that most of their liabilities may be withdrawn on demand, even though this is unlikely to happen to a well-managed bank and will not,

except in the most extraordinary circumstances, happen to the banks collectively. While a very large proportion of its deposits will stay with it if it remains sound and competitive, a bank will still feel reluctant to commit too large a share of short-term borrowings to longer-term investments and will wish to keep a substantial proportion of its assets in forms which can be liquidated quickly if need arises. The liabilities of life insurance companies, on the other hand, are long-term contracts and they therefore tend to seek the higher returns normally available on mortgages and other long-term investments, although they must retain sufficient liquidity to meet insurance claims, policy loan demands and other cash requirements. Thus while institutions do not have to match the maturity of their assets and liabilities in any precise way, indeed cannot do so if they are fully to perform their function of changing the form of the public's financial assets, this consideration naturally exerts a strong influence on their lending preferences.

The legislation under which the institutions operate also influences the character of their business, by prohibiting certain kinds of investment, restricting the ways in which funds may be borrowed and setting other limits to the business they may undertake. The most important of these legal provisions are very familiar: the 8% cash ratio of the chartered banks, the prohibition on their mortgage lending, and the 6% interest ceiling on their loans; the limits on the type and amount of assets in which insurance companies may invest; and the restrictions on trust company unsecured lending. These are only a few examples of the very wide diversity of legal rules within which institutions operate—some are narrowly restricted in their activities and others less so—but in almost all cases the character of the business they do is strongly influenced by the laws governing them. Indeed, even those few financial intermediaries which have grown up without any specific legislation applying to them find it somewhat easier to obtain business because of the restrictions applying to their competitors, although if they are to be lastingly successful in the competition for liabilities they must set themselves high standards of self-regulation.

Finally, each type of financial business calls for particular skills and, indeed, particular physical facilities. Once a company has equipped itself to carry out a particular type of business, be it the operation of chequable deposit accounts or the handling of export finance, it has a natural tendency to stay in that general area. The institution knows its own business and is presumably able to do it better than others. By the same token, the costs and risks of moving into entirely new lines are such that firms cannot alter their essential character quickly, even if the law permits them to do so. They are more likely to grow and develop by branching out into areas fairly closely related to the business they already know and understand.

For the reasons we have suggested, some degree of specialization by institutions is an important characteristic of the financial system. It is by no means the case, however, that the system is made up of separate compartments. There is a good deal of competition among different institutions in each of the main areas of business and each class of institution has tended to shift into new activities which compete with others. Sales finance and small loan companies may specialize in consumer lending, but they must compete for the business with credit unions, with chartered banks to an increasing degree and, indeed, with retail stores and equipment manufacturers. The banks have met increasing competition from many institutions in their traditional preserve, short-term lending to business and industry. Moreover, the intermediaries do not compete only with each other, for their customers are free to borrow from ultimate lenders and invest in direct financial assets. Rather than hold bank deposits or finance company notes, a corporation may invest its surplus funds in debts issued by final borrowers, such as government securities or commercial paper. Rather than borrow from a financial institution a corporation may sell securities to other firms or to individuals. Security brokers and dealers and the markets in which they transact business therefore compete directly with the institutions to fill the

borrowing and investing needs of the public. They, like the institutions, tend to specialize to some degree: for instance, they play a very significant role in business and government finance by distributing stock and bond issues but have not thus far been a major factor in mortgage finance. By the same token they, like the institutions and indeed non-financial enterprises, do move into new financial markets and change the emphasis of their business.

As financial markets have grown and developed, not only in Canada but in other countries as well, the patterns of specialization and competition have changed and the strong forces tending to keep institutions moving along established paths have been overwhelmed by even more powerful innovating influences. Changes in the strength and composition of the demand for funds have led to profitable new types of lending, while the institutions' increased need for funds has led them to compete more aggressively in terms of the rates and special features of their liabilities. Institutional views about the proper relationship between the structure of their assets and liabilities have changed and so have the laws governing them, although not always fast enough. On all sides we found evidence of increasingly varied and dynamic competition and the chapters which follow will examine both the ways in which our financial system has altered in response to these influences and the adequacy of the laws and conventional framework to meet these changed circumstances. In brief, we will be looking for vigour and initiative in the system and, where they seem to be lacking, will try to judge whether anything can be done to foster them.

In an economy such as ours in which we rely to a large degree on the price system to allocate resources among competing users, it is important that that system work well. So far as financial institutions are concerned this means first of all that they be alert to shift the pattern of their investments away from lower-yielding and towards higher-yielding investments within the limits set by law, the risks involved, and the practical possibility of altering their lending practices. If institutions fail to respond to market incentives there is presumptive evidence that the price system is not doing as well as it might in its job of allocating resources in line with the community's preferences. Secondly, prices should operate effectively to allocate funds among the different institutions, the test here being the extent to which institutions make use of price factors in competing for the sale of their liabilities. We would not expect prices to be the only competitive weapon in use since competition in the services provided is also important, but where the price system is for any reason prevented from working, whether by legislation or by the habits and practices of the market, there is a danger that resources will not be allocated in an optimum manner. Thirdly, if the system is working well firms should move into the types of business with higher earnings and out of lines where profits have become poor. In the course of these adjustments, efficient firms with records of good asset management and relatively low expense ratios should fare particularly well. The persistence of wide profit differentials or of striking differences in the apparent efficiency of firms would point to undesirable rigidity and inadequate competition in the financial system.

THE MAIN TRENDS

In the following chapters we trace recent developments in the pattern of our financial system, emphasizing the challenges which have arisen and the responses they have called forth. Attention will focus particularly on the years since World War II, for events in this period are of special importance for an understanding of the direction in which the system is evolving, the obstacles which may stand in the way of healthy growth, and the steps which can be taken to remove them. These recent years must however be set in a broader perspective: Tables 6-2 and 6-3 indicate the growth of the main financial institutions since 1935 and the changes in their relative importance. In 1935 these institutions held $5½ billion of assets, equal to 47% of the outstanding primary debt for which we have records. Their assets rose to a level just under 60% of a more complete compilation of debt

TABLE 6–2

ASSETS OF THE MAIN FINANCIAL INSTITUTIONS
(millions of dollars, year end)

	1935	1945	1950	1955	1962
Bank of Canada	308	2,032	2,350	2,620	3,231
Chartered Banks[a]	2,514	5,997	7,918	10,440	14,848
Quebec Savings Banks	77	143	204	265	357
Trust Companies	225	266	441	714	1,877
Mortgage Loan Companies	230	235	367	570	1,286
Caisses Populaires and Credit Unions	11	140	302	643	1,666
Finance and Consumer Loan Companies[b]	80	100	468	1,244	2,247
Industrial Development Bank	—	10	31	45	181
SUB TOTAL	3,445	8,923	12,081	16,541	25,693
Life Insurance Assets in Canada	1,991	3,125	4,304	6,043	9,950
Pension Funds[c]	n.a.	n.a.	875[e]	1,835[e]	4,572
Mutual Funds[c]	n.a.	n.a.	42	191	710
SUB TOTAL	1,991	3,125	5,221	8,069	15,232
Fire and Casualty Insurance Assets in Canada	226	234	563	929	1,585
TOTAL[d]	5,662	12,282	17,865	25,539	42,510
Primary Debt Outstanding	12,163	25,961	31,721	44,050	71,983
Institutional assets as a per cent of primary debt	47%	47%	56%	58%	59%

[a]Canadian plus net foreign assets, excluding items in transit.

[b]In order to provide a consistent series we exclude some assets for which information is not available prior to 1960. At the end of 1962 total assets were $2,689 mn. compared to the $2,247 mn. shown.

[c]Data for pension funds and mutual funds in 1935 and 1945 are not available, but the amounts are known to have been small.

[d]The amounts shown include claims on financial institutions held by other institutions in the Table, for instance loans and holdings of cash. Thus, the total includes some double-counting of institutional assets.

[e]Estimated

by the mid-1950's and the relationship has remained fairly steady since then. The strong post-war demand for funds, particularly for mortgage and consumer credit, a large share of which tends to come from financial institutions, stimulated their growth during these years. Since the mid-fifties there has been some tendency for the expansion of direct financing through the markets to check the increase in institutional financing: an important example has been the increasing use of the commercial paper market by borrowing corporations which formerly relied very heavily on banks for their short-term needs.

In 1935 the financial system was dominated by the banks and the insurance companies, which accounted for almost 80% of all institutional assets. The banking system, as a major contributor to war finance, grew still further in the ensuing decade while the shares of all other institutions except the credit unions fell; the expansion of the Bank of Canada in this period was also partly due to its taking over the note-issuing function. But from that point on new forces in the economy favoured the growth of other institutions. In the group of short-term institutions shown at the top of the tables, the banks grew less rapidly than some others, notably the trust and loan companies, credit unions and finance companies. (Classifications of institutions are bound to be arbitrary: in these tables we include trust and loan companies in the "short-term" or "near-bank" group because many of their liabilities are much closer to those of banks than to those of the "long-term" institutions grouped below.)

TABLE 6–3

ASSETS OF THE MAIN FINANCIAL INSTITUTIONS
(percent distribution)

—	1935	1945	1950	1955	1962
Bank of Canada	5.4	16.5	13.2	10.3	7.6
Chartered Banks	44.4	48.8	44.3	40.9	34.9
Quebec Savings Banks	1.4	1.2	1.1	1.0	0.8
Trust Companies	4.0	2.2	2.5	2.8	4.4
Mortgage Loan Companies	4.1	1.9	2.1	2.2	3.0
Caisses Populaires and Credit Unions	0.2	1.1	1.7	2.5	3.9
Finance and Consumer Loan Companies	1.4	.8	2.6	4.9	5.3
Industrial Development Bank	—	0.1	0.2	0.2	0.4
SUB TOTAL	60.8	72.7	67.6	64.8	60.4
Life Insurance Assets in Canada	35.2	25.4	24.1	23.7	23.4
Pension Funds	n.a.	n.a.	4.9	7.2	10.8
Mutual Funds	n.a.	n.a.	.2	.7	1.7
SUB TOTAL	35.2	25.4	29.2	31.6	35.8
Fire and Casualty Insurance Assets in Canada	4.0	1.9	3.2	3.6	3.7
TOTAL	100.0	100.0	100.0	100.0	100.0

Within this group of institutions (excluding the Bank of Canada) the banks' share has come down from 87% in 1945 to 66% at the end of 1962. The others have taken advantage of the strong demand for mortgages and consumer finance and of the developing short-term money market to compete aggressively with banks for the necessary funds. The banks have been inhibited by restrictions on their investment powers from moving into conventional mortgage lending, although since 1954 they have been able to acquire N.H.A. mortgages. This restriction has contributed to the loss of position by banks, although in saying this we do not under-estimate the vigour with which other institutions have seized the opportunities open to them. On their part the banks have responded by developing their consumer financing activities rapidly during the past five or six years and now hold a large and increasing share of this market. Thus on both the borrowing and lending sides of their business, the banks have experienced vigorous and varied competition.

Life insurance companies, the largest long-term institutions, have also been faced with strong competition from newer institutions. Pension funds have grown very rapidly and now hold over 10% of institutional assets, almost one-half the share held by insurance companies, and the mutual funds have also become a prominent part of our financial system. Thus life companies, which were virtually alone in the long-term contractual savings field in 1935, are now competing with two other collectors of similar savings which have assets over half as much as their own.

There are some financial institutions not included in Tables 6-2 and 6-3. First of all there are three savings institutions operated by governments, the federal Post Office Savings Bank, the Province of Ontario Savings Office and the Alberta Treasury Branches. They have grown very slowly in recent years: at the end of 1961 deposits of $196 million were almost unchanged from the level reached five years earlier. (In 1962 a fourth such institution in Newfoundland was acquired by a chartered bank.) Each of the provincial institutions accepts chequable as well as time deposits: funds deposited with the Post Office Savings Bank may only be withdrawn on application to the offices, and for withdrawals over $100 the depositor must make application direct to Ottawa. The federal and Ontario institutions advance all funds collected to their governments and are thus a means by which the governments borrow from the public. Indeed, it was this factor, rather than the needs of the public, which was instrumental in their establishment, and the lack of need for such institutions in recent years has undoubtedly accounted for their slow growth. On the other hand, the Alberta Treasury Branches were established in the 1930's to provide banking and credit services—although there were other reasons as well—and they therefore lend to the public in addition to investing in provincial securities.

Apart from these government institutions, there are a great many private institutions for which statistical information is not available, and which do not therefore appear in the tables. There are for instance many new small mortgage, leasing, commercial financing and factoring companies obtaining their funds both from the public and from other financial institutions. The business done by such companies probably does not bulk large, but their development in recent years is further evidence of the increasing diversity of institutions appearing in the financial system in response to particular needs. Finally, there have been a number of institutions—some of them sizable—established with the object of making long-term loans and equity investments in smaller or newer enterprises which do not have easy access to the capital markets and whose needs cannot be completely provided by other institutions. These institutions supplement the services provided by the government-owned Industrial Development Bank which was established in 1944. Many of these miscellaneous institutions are not subject to regulation by any supervisory authority and some indeed do not publish information on their affairs.

In the course of the growth and development of the last three decades, and particularly since the end of the war, the financial institutions and markets have become much more flexible and competitive. While there are still traces of a reluctance to change and of an exaggerated reliance on prestige in some institutions, it is generally true that the opportunities for undertaking profitable new lines of business and the sweeping changes in the financial environment both at home and abroad have caused undue conservatism and lack of imagination to give way to a more adventurous and innovating spirit. Thus the older institutions have undergone pronounced changes in their character and attitudes and have moved into new lines of business, while on all sides a greater willingness to compete by price and other measures has accompanied the growth of more vigorous and varied intermediaries and markets. In this changed environment, a failure to compete is much more likely to result in a loss of position to the institutions concerned than it is to produce fundamental damage to the economy as a whole, since the traditional division of the financial business into semi-private preserves has been replaced by a more open system in which virtually no-one feels bound to stay only in the field where he first got his start, and almost everyone is subject to competition from both newcomers and established institutions.

APPENDIX TO CHAPTER 6

A NOTE ON INSTITUTIONAL COMPETITION AND CASH RESERVES

All institutions are affected by changes in monetary policy regardless of the form and location of their cash reserves. The different institutions' experience in recent years, which is reviewed in the following chapters, bears out the view that their competitive positions, relative growth rates and response to monetary policy turn on their success in persuading others to hold their liabilities. This is related to the interest rate and other inducements they are able to offer, which in turn are governed by their earnings on assets and services. Those which succeed will gain and retain cash reserves which enable them to make new investments: the reverse proposition, that those having extra cash will expand more rapidly, puts the matter the wrong way round, for they only come into excess cash as a result of their success in attracting business.

In this note we elaborate on this proposition by working through a number of simplified examples, dealing first with banking institutions holding their reserves at the central bank and then with the position of institutions whose reserves other than coin and bank notes are held outside the central bank.

(i) *Institutions With Central Bank Reserves*

The response of the chartered banks to changes in their cash reserves brought about by the central bank has been described in the chapter. In general, the banks—all of which hold reserves of central bank notes and deposits equal to 8% of their deposit liabilities—will tend to expand or contract by an aggregate $100 for each $8 change in their combined reserves. Individual banks will expand or contract at differing rates depending on their success in attracting holders of their liabilities.

This would be true whether or not the banks were required to meet identical reserve requirements. The fact that one institution worked to a lower cash ratio than another would place it in a stronger competitive position than its rival, other things being equal, since its proportion of earning assets would be higher. However, the lower cash ratio would not in some mechanical way enable it to "multiply" its assets and liabilities more rapidly than the high-ratio institution. Suppose, for instance, that there were two banks of equal size, one holding reserves equal to 4% of its deposits and the other holding 12%, and that the competitive situation was such that each bank attracted one-half of new deposit business. If the central bank acts to increase total reserves and—to take the extreme case—the low ratio bank initially obtains all the new cash by selling securities directly to the central bank, the situation will be as follows:[1]

	Bank A (12% reserves)		Bank B (4% reserves)		Total	
	$	%	$	%	$	%
Cash	120	12.0	48	4.8	168	8.4
Other assests	880	88.0	952	95.2	1,832	91.6
TOTAL	1,000	100.0	1,000	100.0	2,000	100.0

Bank B, which held cash of $40 and other assets of $960 before this transaction, now has excess cash and sets about investing it in earning

[1] The example is simplified by assuming that the reserve ratio applies to total assets or liabilities rather than deposits only, but this does not affect the argument.

assets, creating new deposit liabilities as it does so. Given the institutions' competitive positions (and nothing has happened to alter them) one-half of these will be deposited with Bank A, with Bank B retaining one-half of the new deposits and one-half of the new cash. Both banks now have excess cash, and as each invests it in earning assets the same process will continue, deposits and cash being transferred between them in proportion to public preferences for the holding of their liabilities. On our assumptions, they will expand roughly in step until they reach the new equilibrium where each is at its preferred minimum cash ratio position as follows:

——	Bank A		Bank B		Total	
	$	%	$	%	$	%
Final Position						
Cash	126	12.0	42	4.0	168	8.0
Other assets	924	88.0	1,008	96.0	1,932	92.0
TOTAL	1,050	100.0	1,050	100.0	2,100	100.0

Any attempt by a bank to invest in earning assets faster than it can attract deposits will cause it to lose a matching amount of cash. We have assumed that the two banks share equally in new deposit business, but this of course need not be the case. If public preferences change or one institution is able to compete more successfully than the other in finding holders for its liabilities (perhaps because higher asset yields or lower expense ratios enable it to raise the payments on its liabilities relative to its competitor) it will retain a higher share of the new deposits. It will thus retain more of the cash reserves at each stage of asset expansion and be able to grow more rapidly than the other. For instance, the first of the following approximate equilibrium positions would be reached if Bank A were able to attract three-quarters of all new deposits, and the second if Bank B were as successful:

——	Bank A		Bank B		Total	
	$	%	$	%	$	%
Cash	127.2	12.0	40.8	4.0	168	8.1
Other assets	932.8	88.0	979.2	96.0	1,912	91.9
TOTAL	1,060.0	100.0	1,020.0	100.0	2,080	100.0
Cash	124.0	12.0	44.0	4.0	168.0	7.9
Other assets	909.3	88.0	1,056.0	96.0	1,965.3	92.1
TOTAL	1,033.3	100.0	1,100.0	100.0	2,133.3	100.0

It will be noted that the banking system as a whole expands further on a given increase in reserves if the low ratio bank is more successful in attracting funds and expands less if the high ratio bank attracts a larger share. Within the mechanical terms of this discussion, which takes no account of competing interest rate adjustments or further central bank response to market developments, this might introduce some uncertainty into the response of the banking system to a change in its reserves. However, in view of the fact that relative growth rates are unlikely to fluctuate suddenly, the uncertainty about bank responses will not be great.[2] It would be increased if banks were to change their reserve ratio policies unpredictably. In the present case, a decision by Bank A that it could work with 10% reserves rather than 12% would have the same effect as an increase in the cash reserves supplied by the central bank. The excess reserves would circulate among the banks and enable all of them—not just A—to grow in proportion to their success in competing for new business. Assuming that they obtain equal shares of the new deposits and

[2] It is thus possible for the central bank to exercise monetary control without imposing uniform cash ratios on the institutions as long as each institution always works to a specified ratio known to the central bank, although it would add to the complexity of the authorities' task. See the submission of the President of the Royal Bank of Canada and the Transcript, pp. 8470 ff.

each started with deposits of $1,000 the final position would be:

——	Bank A		Bank B		Total	
	$	%	$	%	$	%
Cash	114.3	10.0	45.7	4.0	160.0	7.0
Other assets	1,028.7	90.0	1,097.3	96.0	2,126.0	93.0
TOTAL	1,143.0	100.0	1,143.0	100.0	2,286.0	100.0

Thus if the central bank takes no offsetting action to reduce total reserves below $160, the banking system as a whole can expand by $286. If, however the banks hold specified and uniform ratios of central bank reserves they cannot as a group expand because the total amount of available cash is fixed by the central bank and reserves gained by one bank are lost to others.

(ii) *Institutions Holding Reserves Outside the Central Bank*

Central bank action also affects institutions holding their reserves in the form of currency and deposits with private institutions, principally with the chartered banks. When bank deposits expand, funds will be deposited[3] with other institutions in proportion to their success, relative to the banks, in attracting holders of their liabilities. (This must happen unless there is a change in public preferences, relative rates of return or other inducements sufficient to persuade the community to hold the entire increase in its financial assets in the form of bank deposits.) In the case mentioned in the text, if the "outside" institutions are one-half the size of the banks and retain this competitive position during the process, one dollar of funds will be deposited with them for each two dollar increase in bank deposits. The increase in their reserves will enable them to expand in step with the banks. In opposite circumstances funds will be withdrawn from them and they will contract in step with the banks.

The "outside" institutions are not in precisely the same position as the chartered banks because the aggregate amount of their reserves is not fixed by the central bank. Their reserves are part of the entire pool of bank deposits and they are able to increase their reserves by bidding for a larger share of bank deposits from other holders. However they cannot gain and hold a higher share of business and cash reserves unless they improve the terms offered on their liabilities. If the banks retaliate by raising their own deposit rates—within the limits set by their earnings—they will restrict the ability of the outside institutions to grow at their expense. Low reserve ratios or reserves held outside the central bank are thus not the key to relatively rapid growth. This is determined only by the balance of liability competition. Even on the extreme assumption that these outside institutions became three times as large as the banks and retained this share of new business this conclusion would still hold true.

If the outside institutions are successful in bidding for new liabilities because of changes in public preferences or in their own competitive and earnings position, the system as a whole will of course expand. When they invest in earning assets, assuming no further change in the public's willingness to hold bank liabilities and liabilities of the other institutions, they will lose some of their newly-acquired excess reserves to other holders of bank deposits with each round of investment. Total bank deposits will be unchanged at the end of the process, but more of them will be held by the other institutions and less by the general public. The extent of the expansion of the system as a whole will thus depend upon the size of the outside institutions, their cash ratios and the extent of the shift in public preferences.

If, for example, the original position was that the banks had $1,000 of deposits (of which the other institutions held $150) and the outside institutions had $3,000 and successfully bid for

[3] That is to say, funds will be invested in their deposits, certificates, debentures and other liabilities.

$10 more cash their position would develop as follows:

"OUTSIDE" INSTITUTIONS

——	Initial Position		Position after initial cash gain		Approximate Final Position	
	$	%	$	%	$	%
Cash (bank deposits)	150	5.0	160	5.3	152	5.0
Other assets	2,850	95.0	2,850	94.7	2,887	95.0
TOTAL	3,000	100.0	3,010	100.0	3,039	100.0

Following the initial increase of $10 in these institutions' reserves, the public would hold $840 of bank deposits and $3,010 of claims on the other institutions, i.e. the proportions of their combined holdings would be about 21.8% and 78.2% respectively. During the process of expansion the outside institutions will retain cash in proportion to this new structure of public preferences and at the end the public will still hold 78.2% of its combined claims on the banks and other institutions with the latter. The assets and the liabilities of the entire system to the public have expanded by just under 1%.[4]

Similarly, the whole system will expand if the outside institutions run down their cash ratios, all other factors unchanged; the extent of the expansion will again depend upon the size and competitive position of the outside institutions—which determines the flow-back of cash to them—and the extent of the change in ratios. If the outside institutions had $3,000 of deposits compared to $1,000 for the banks and decided to reduce their cash ratios drastically—say from 5% to 1%—the original and final positions would be (assuming no other changes in market shares resulting from shifting public preferences or other factors):

——	Initial Position		Final Position	
	$	%	$	%
Cash (bank deposits)	150	5.0	34	1.0
Other assets	2,850	95.0	3,375	99.0
TOTAL	3,000	100.0	3,409	100.0

In this case, the public initially held $3,000 of its claims with the outside institutions and $850 with the banks. Assuming these market shares of 77.9% and 22.1% respectively remain unchanged until the end of the adjustment, the public will finally hold $966 of bank deposits and $3,409 of other institutional liabilities—i.e. its total holdings of financial assets will have expanded by 13.6%, with the percentage increase in public holdings being the same for both classes of intermediary. The combined assets of the institutions have, however, grown by only 10.2%, reflecting the lower cash holdings of the outside institutions.

In each case, the loss of cash to other holders of bank deposits in proportion to public preferences for holdings of the two types of asset brings the expansion to a halt fairly rapidly, even if neither the banks nor the central bank respond to the expansion of the system resulting from the shift of business. Moreover, as mentioned above, the banks can impede the expansion of their competitors by matching the increases in the returns paid on their liabilities, thus preventing the shift of cash and financial business to the other institutions. The crucial element in the situation is not the form and level of cash reserves but the ability and willingness of the banks to transmit the effects of pressure on them to others by adjusting their deposit rates to the competitive situation.

[4] Here, as throughout this discussion, we ignore the change in the public's desire to hold currency which might accompany changes in their holdings of other claims. Moreover, the examples do not take into account the fact that claims on the institutions compete with many other assets for a place in the public's portfolios: the processes of expansion thus involve more than competition between the two groups of institutions in the examples. Finally, the example is simplified by assuming that there is a once-over shift in the public's preferences; the outside institutions will grow more rapidly if further shifts cause the share of their new business to exceed that prevailing after the original change.

CHAPTER 7

THE CHARTERED BANKS

There was a day when a description of the banks alone would have served to describe virtually the whole Canadian financial system. Many other institutions have since grown up to compete with the banks or develop new lines of business and the central bank and governments now play a much more active role in public policy, but the chartered banks remain in many ways the heart of the private financial system. They are the country's largest deposit institutions, its main source of short-term credit, and managers of its payments system. They have an especially wide range of dealings with all parts of the community and their activities thus have an important influence on the financing decisions of individuals, businesses, and even governments. Competition has made them more flexible and shrunk their once awesome status, but the chartered banks are still by far the biggest and most prominent of Canada's financial institutions.

At one time there were many banks in Canada, some private and some "chartered" by governments. By and large they were local institutions issuing notes which circulated in their own areas and concerning themselves very little with the affairs and requirements of other parts of the country. Although the early charters did not always clearly permit branching it was never prohibited, and as business and commerce became more national in character some of the banks began to expand their horizons. Branches were opened in the more important centres and business relations were established in other provinces. In the United States a system of local "unit" banks was deliberately fostered, but in Canada the first Dominion legislation explicitly allowed branch openings and thereby encouraged a system of national banks to develop. Following Confederation nineteen banks operated under Dominion charters, a number which increased to thirty-eight by 1886 and remained little changed until the eve of the First World War. Since then failures, amalgamations and mergers have reduced the number to the present eight, of which five have national branch systems, two operate principally in the province of Quebec, and one has branches only in Montreal, Toronto and Vancouver.

In this chapter we first outline the main provisions of the Bank Act and then describe the banks' domestic business. The emphasis is on post-war trends in the size and nature of their deposit, lending, and investing activities and on recent competitive developments. The next section deals with the banks' response to changes in monetary policy, following which we describe their foreign currency business. We then comment on the system of regulation and supervision and conclude with a brief description of working relationships between the banks and other financial institutions.

THE BANK ACT

Any group wishing to incorporate a bank and obtain a charter under the Bank Act must

meet certain requirements. Capital of at least $1,000,000 must be subscribed and $500,000 of this must have been paid in. The Inspector General of Banks is not aware of any cases where the capital requirement itself has stood in the way of a new bank and told us that new banks have tended to exceed the minimum required in the Act.[1] The founders of other than a small local bank would unquestionably need more capital than is required by law in order to meet initial expenses and early operating losses. Indeed, it appears that the authorities would refuse incorporation to any bank unless the capital were considered adequate.

A bank must have at least five directors, a majority of whom are "subjects of Her Majesty ordinarily resident in Canada"; an age limit of 75 has been in force since 1954 but no other personal qualifications are specified. We received representations that the directorates of banks were unduly large, that business borrowers had too much weight on the board, and that the directors ought to be more representative of the community as a whole. While we agree that bank boards ought to be as broadly representative as is consistent with bringing experienced business judgment to bear on the affairs of the bank, we do not believe there should be any legislated composition of bank boards. However, the present requirement in the Act that three-quarters of the directors of a bank with paid-up capital of over $3 million must hold at least 500 shares of bank stock[2] seems unduly onerous and a deterrent to drawing directors from a wider stratum. This requirement has at times necessitated an investment in excess of $40,000. It may have been reasonable when the shares were selling close to their $10 par value, but we believe directors would have an adequate sense of commitment to the other shareholders if the qualifications were lowered to an initial investment of $5,000, no matter how many shares that represented.

In addition to meeting these requirements, the founding group must satisfy the Treasury Board that the initial expenses of the bank are reasonable. Once these legal conditions have been met, and provided that not more than a year has passed since the original application was made, Treasury Board, may at its discretion issue a certificate permitting the new institution to "commence the business of banking". The Inspector General told us that apart from expecting the bank to have somewhat more capital than the law requires and having an interest in the character and standing of the group making application, the government does not set out other requirements.

The directors are responsible for the bank's affairs, elect a president and vice-presidents from their own number, may make any by-laws except in relation to their own remuneration, and appoint the officers and employees of the bank. The only restriction on their powers appears in Section 75 which specifies that loans in excess of 5% of paid-up capital "to a director of the bank or to any firm or corporation of which a director or the general manager of the bank is a member or shareholder" must be approved by two-thirds of the directors present, and the director may not be present at the discussion of any loan in which he has an interest. About 30% of the banks' authorized lines of credit of $100,000 or more at the end of 1962 were to directors, their firms, or corporations of which they were officers or directors, or were guaranteed by them. However, this is a reflection of the wide business interests of the 270 directors and there is no evidence of any abuse which has come to the attention of the Inspector General.

Unfortunately "the business of banking" is not defined in the Bank Act or, for that matter, anywhere else. Indeed, while Section 157 prohibits the use of the term "bank" by institutions not authorized under the Act or other legislation, it nowhere prohibits others from engaging in bank-

[1] Transcript, page 8537.

[2] The remaining one quarter of directors are required to hold at least 250 shares. Directors of any bank with paid-up capital of one million dollars or less must hold 300 shares, with one quarter of the board permitted to hold 150. If paid-up capital is between one and three million dollars the requirements are 400 and 200 shares.

ing activities. As to the institutions chartered under the Act, Section 75 lists a number of things which a bank may do, such as open branches and make loans, and then states: "the bank may engage in and carry on such business generally as appertains to the business of banking." So far as borrowing powers are concerned, the Act now prohibits a bank from issuing demand notes intended for circulation in Canada, the note issue having been assumed by the Bank of Canada. Of much greater importance is Section 95 under which banks may receive money on deposit from anyone, transfer it on his orders and pay any rate of interest on deposits. The Act does not mention any other form of borrowing by a bank, either to allow or to prohibit it. In effect all bank liabilities other than shareholders' equity, contingent liabilities under letters of credit, guarantees and acceptances and a small amount of minor items are considered to be deposits, regardless of the terms and conditions of the liability. For instance, notes sold by banks for terms up to six years are held to be deposits and cash reserves must be held against them. Moreover the Act no longer lays down any statutory limit on the relationship of capital to other liabilities such as is found in trust and loan company legislation, although earlier bank legislation and charters did set up ratios of this sort with respect to bank note issues and other borrowing.

Thus, the types of liability which a bank may issue are so broadly defined as to be virtually unlimited. The same does not hold true of the banks' lending and investment activities, which are restricted in some respects and favoured in others. The general intent of Canadian banking legislation has been to permit lending against any form of security other than mortgages and bank stock. The prohibition on mortgage lending has in one form or another found a place in Canadian banking legislation from the earliest days reflecting the traditional view that a bank's assets should be kept very liquid to ensure the safety of its note and deposit liabilities. However, as a result of a series of amendments to the Bank Act as well as a number of other Acts of Parliament the prohibition in Section 75(2)(d) on lending "upon the security of real or immovable property, or of ships or vessels, or of goods, wares and merchandise" has been whittled down. Banks may make guaranteed mortgage loans under the National Housing Act, the Farm Improvement Loans Act, the Veterans Business and Professional Loans Act and the Small Businesses Loans Act, and are not prohibited from acquiring or lending on the security of mortgage bonds or debentures of a corporation. They have been permitted since 1954 to take chattel mortgages on loans to individuals, and under Section 88 and related parts of the Act have been able for many years to lend against goods in the process of manufacture and distribution. The banks are also permitted by Section 78 to take a mortgage as "subsequent security" for any loan made in the ordinary course of business, a provision which is used to obtain additional security for loans on which payments are slower than originally agreed or which have otherwise become unsatisfactory. However, with these exceptions, the banks are precluded from taking direct mortgage security, including conventional residential mortgages. They argued strongly that this remaining part of the historic general prohibition on mortgage lending should be removed. Since such a change would have important consequences for the mortgage market and for other lenders it will be considered later in the report.

We have mentioned "Section 88", perhaps the only part of the Bank Act which is widely known by its number. This is the most important of a number of sections which set out procedures by which a bank may lend on the security of goods in the process of being worked up for market or on the security of a warehouse receipt or bill of lading. The earliest ancestor of this part of the Act made its appearance in 1859 in legislation passed by the Province of Canada which provided that a bank might lend on the security of a bill of lading, or a warehouse receipt given by a "warehouseman, miller, wharfinger, master of a vessel or carrier", when endorsed to the bank by the owner of the goods.[3] Two years later an amend-

[3] A. B. Jamieson, *Chartered Banking in Canada*, The Ryerson Press, Toronto, 1959; page 11 ff.

ment permitted a warehouseman or other custodian who owned the goods himself to borrow against them. In 1890 a revision made it possible for manufacturers and wholesalers to borrow on the security of specified goods in the process of production or distribution. Later changes in the pledge provisions have broadened them and simplified procedures. These sections enable borrowers not having "paper" collateral to obtain bank financing since a bank holding duly registered security under this part of the Act is specifically given a first lien on the property concerned. This preferential feature of Section 88 and surrounding sections is doubly important since ordinary mortgage security is not generally permitted to a bank.

Under Section 91 of the Act, a bank may not charge a rate of interest or discount higher than 6% per annum on any loan or advance payable in Canada. A maximum limit on loan interest was set in an ordinance promulgated in the Province of Quebec in 1777 and passed from there into the first bank charters granted in the province and thence into the Bank Act. The present 6% has applied since 1944 when the level was reduced from the 7% maximum established in 1867. The banks have urged that this limit now be removed since it precludes them at times from attractive lending business, distorts markets by concentrating excessive demands on them when market rates exceed 6%, and reduces their ability to compete for deposits with other institutions to whom the ceiling does not apply. As in the case of the argument for removal of the mortgage prohibition, this suggestion has far-reaching implications for the financial system and will be examined later in a broader context.

The Act sets one very important limit on the structure of bank assets in Section 71, in which each bank is required to maintain a cash reserve in the form of Bank of Canada notes and deposits equal to at least 8% of average Canadian deposits. This is the only point in the Bank Act, indeed the only point in legislation covering any private financial institution, at which the needs of the central bank and monetary policy put in an appearance. Taken with the powers given the Bank of Canada under its own legislation this minimum cash requirement assists the central bank in influencing the operations of chartered banks and credit conditions generally. It also has the incidental but important effect of obliging banks to forego any earnings on this portion of their assets.

The Bank Act also precludes the banks from carrying on certain types of business, although the relevant sections are not always precisely phrased. Section 75(4) states that no officer or employee of the bank shall act as agent in the placing of insurance and Section 157 prohibits the use of a bank's name in a prospectus or advertisement for the sale of securities other than federal issues. Section 75(2)(b) states more generally that a bank may not "deal in goods, wares and merchandise or engage in any trade or business" and this injunction, taken with Section 75(1)(e) which permits a bank to "carry on such business generally as appertains to the business of banking", has been generally interpreted to imply that a bank may not control another business. However, Section 58, by obliging the banks to annex to their own annual statements the statements of controlled corporations through which they carry on any part of their operations, makes it clear that banks may own and operate other companies: they do in fact have subsidiary realty companies and foreign trust and banking companies. Finally, banks are clearly prohibited from purchasing or lending against bank stock. We will return again to the broader general questions of the appropriate limits to a bank's activities and its relationships to other corporations.

The Bank Act now contains quite detailed audit and inspection requirements, which came into the legislation gradually as a consequence of weaknesses revealed by bank failures. Section 61 sets out the qualifications required of shareholders' auditors and outlines their duties to enquire closely into the affairs of the bank and report to the officers and shareholders on its well-being. The following section appoints the Inspector General of Banks, an official of the federal Department of Finance, and gives him broad powers to inspect the banks and report to the Minister of Finance

on their soundness. In order to provide the supervisory authorities and others with information on their business, banks are also required to prepare and submit to the government and to shareholders a substantial number of statistical returns.

Another piece of legislation relating to banks is the Canadian Bankers' Association Act. The Association was founded as a voluntary organization of bankers in 1891 to promote their common interests by arranging courses for bank officers and maintaining an interest in legislation affecting the banks. In addition, the Association was to take any necessary action to protect the banks' interests as contributors to the Bank Circulation Redemption Fund which had been established in the Bank Act Revision of 1890 to redeem notes of failed banks. The purposes and functions of the Association were given official sanction when the Canadian Bankers' Association Act was passed in 1900, at which time the Association also received powers to establish and operate a clearing system. The Association has continued to develop as a focus for educational activities and as a forum for meetings about matters of common interest. In addition to such normal functions of a trade association it operates the clearing system, subject to approval of the regulations by Treasury Board, and employs foreign exchange brokers in Montreal and Toronto.

While there are a great many other provisions in the legislation governing banks, those which we have mentioned, together with the long established requirement that the legislation be reviewed every ten years, are the important ones. Most of the remainder of the Bank Act is taken up with detailed elaboration on these topics and with a number of secondary matters such as the rules and regulations relating to share transfers, permission to destroy old records and the penalties for breach of various clauses in the Act. The general intent is clearly that duly chartered banks should be free to carry on a fairly broad range of financial business subject to the few important limits mentioned and to close, continuing audit and inspection. The legislation under which some other financial institutions operate is of a somewhat different character, being much more concerned to define and restrict their borrowing and investment powers than to rely on the free choice of management and competent supervision to ensure their safety. One cannot categorize all financial legislation neatly in this way, but we do find the two approaches present and the Bank Act is by and large of the first type.

BANK DEPOSITS

The principal features of the domestic deposit business of the banks may be quite briefly summarized. They offer current accounts, personal and corporate savings accounts and personal chequing accounts, and at the end of 1962, $12.7 billion out of total Canadian dollar deposit liabilities of $13.7 billion was held in one or other of these chequable deposit accounts.[4] In addition, $1.0 billion of non-chequable term deposits or deposit receipts was outstanding. A very high proportion of Canadian payments are made by means of cheques on chartered bank accounts; current accounts, which turned over 68 times in 1961 compared to about 1½ times for savings accounts, are used for most of these transactions. Since, with few exceptions, other deposit-taking institutions such as trust companies, loan companies, savings banks and credit unions in turn carry their own accounts directly or indirectly with the banks, there is very little deposit business which does not pass through the banks' hands in one way or another.

That the banks thus borrow funds from a very broad range of customers is illustrated by the fact that at September 30, 1963 they had almost twelve million personal savings accounts and nearly three million other deposit accounts on their books in Canada, compared to a total population of 19 million.

Personal savings deposits are widely used by individuals both as a savings instrument and as working accounts through which pass the regular flow of their income and spending. While small accounts used for chequing purposes are by far the most numerous, the bulk of the funds on

[4] Although savings deposits are formally withdrawable only after notice has been given, this is never in practice required.

NUMBER OF DEPOSIT ACCOUNTS, CLASSIFIED BY SIZE

(September 30, 1963)

—	Personal Savings Deposits	Other Deposit Accounts
Less than $100	6,468,580	1,438,893
$100 to $999	3,436,216	1,005,848
$1,000 to $9,999	1,807,534	397,425
$10,000 to $99,999	98,820	67,647
$100,000 and over	1,088	6,744
	11,812,238	2,916,557

deposit are in a relatively small proportion of accounts whose owners regard them as a more permanent, yet conveniently accessible, form of interest-bearing investment. In 1957 the banks introduced "personal chequing accounts" in an attempt to encourage individuals making active use of their savings accounts into using a distinct deposit category paying no interest but providing regular statements and charging less per cheque. However, the public continues to prefer savings accounts and in early 1963 there was only about $120 million on deposit in personal chequing accounts, less than 1% of total bank deposits. These accounts had, however, attracted some of the more active balances, and had a turnover more than ten times that of the average savings account. Current accounts are held mainly by business and are used by them for all their normal payment needs and to a limited extent as a reserve of liquid assets. They are also held by governments and by other financial institutions as cash reserves and working balances. Finally, the banks accept funds in non-chequing term accounts against the issue of "deposit receipts" with maturities up to 364 days and some banks accept such funds for longer terms. These are the main classes of Canadian dollar accounts made available by banks, but they also offer foreign currency deposits to Canadians who need foreign exchange balances in the course of their business or who seek this type of short-term investment.

Since each class of deposit is sold in a somewhat different market, it has grown in response to a particular set of influences. Current accounts, which now constitute about one-third of Canadian dollar deposit liabilities, have grown more slowly than other types of account since the war. From 1950 to 1962 they increased by only 59%, compared to 90% for personal savings deposits and 160% for other notice deposits. Within the current accounts, balances held by business firms appear to have grown at about the same pace as the total—an increase of just under 60% since 1950. This relatively slow rate of growth has been due to competitive forces, but not to competition from other institutions offering the same or better current account service. The evidence indicates that the banks continue to have almost all the current accounts of businesses but that businesses have learned to work with smaller accounts. Instead of holding non-earning cash balances, enterprises have tended to invest where possible in a variety of short-term financial assets, with the result that the demand for current accounts has grown relatively slowly.

Among the earning assets into which business firms and others have been attracted have been the fixed-term and corporate notice deposits of the chartered banks themselves which have grown from around $300 to $400 million in 1950 to their present level of $1.2 billion. Under pressure of competition from other short-term investments such as treasury bills, trust company deposits and certificates, finance company and commercial paper and investment dealer loans and buy-backs, banks have been competing more aggressively by improving the rates paid on their term deposits. At the end of 1953, the rate on balances of $100,000 or more was raised from ½% to 1½%, where it remained until late 1955, while treasury bill rates varied from just below 1% to 2½%. From December 1955 until 1960, the banks set their rate on these large balances just below current rates on treasury bills. Since the beginning of 1961, they have paid rates on deposit receipts with a term from 30 days to a year which have frequently exceeded the treasury bill rate and have lowered the minimum size of deposit on which these rates will be paid to $25,000. These steps have enabled them to at-

TABLE 7–1

CANADIAN DOLLAR DEPOSITS
(December 31)

—	1926		1935		1945		1955		1962	
	$ millions	%	$ millions	%	$ millions	%	$ millions	%	$ millions	%
Personal savings deposits	n.a.	—	1,300[e]	62.2	2,635	46.5	5,633	57.2	7,932	57.9
Other notice deposits	n.a.	—	186[e]	8.9	230	4.1	464	4.7	997	7.3
SUB TOTAL	1,373	72.2	1,486	71.1	2,865	50.6	6,097	61.9	8,929	65.2
Current accounts[a,b]	528	27.8	603	28.9	2,802	49.4	3,749	38.1	4,759	34.8
TOTAL[a]	1,901	100.0	2,089	100.0	5,667	100.0	9,847	100.0	13,689	100.0

[a]The net amount of Canadian dollar items in transit has been deducted from these items.
[b]Includes deposits of governments and other banks as well as public demand deposits and personal chequing accounts.
[e]Estimated.
SOURCE: *Canada Gazette* and *Bank of Canada Statistical Summary.*

tract an impressive volume of funds and to hold an increasing share of the market in short-term investments.

Through their personal savings deposits, the banks are in competition with a wide range of institutions and other borrowing instruments such as savings bonds for the savings of individuals. Although savings deposits have grown more rapidly than the banks' current accounts, the banks have in recent years lost ground relative to others in the competition for funds.

The assets included in Table 7-2 are not all perfect substitutes for one another—some are money, some are not, some are demand instruments while others represent investments for varying terms—but they are to a meaningful degree alternative forms in which personal savings may be held. Although it must also be noted that these assets are not held exclusively by individuals—trust and loan companies probably borrow one-third of their funds from corporations[5]—a significant pattern of changing market shares nonetheless emerges. Over the period since 1945, chartered bank personal savings deposits have risen less rapidly than any other item in the table except deposits in Quebec Savings Banks and in the government institutions. The chartered banks' share of the market has declined from 73% at the end of World War II to 46% in 1962, has fallen in every year since 1950, and has dropped at a somewhat more rapid rate since the end of 1958 than previously. The banks' loss of position has been accompanied by a rapid increase in claims on trust companies, loan companies, credit unions and caisses populaires and in public holdings of Canada Savings Bonds; a good part of the latter is sold by the banks themselves.

A great many competitive factors influence the distribution of savings among bank deposits and other financial assets, and it is never possible to determine exactly how much weight should be given to each. The nature of the asset offered—whether money or a less liquid instrument—the ease or difficulty with which customers may invest and withdraw their funds, the location of offices and hours of business, the risk of loss, and the other facilities available to the customer such as safekeeping and the possibility of borrowing when occasion arises, all enter as elements in the competition for funds. To the extent that

[5] *The Role of Trust and Loan Companies in the Canadian Economy*, a study prepared at the University of Western Ontario for the Trust Companies Association of Canada, Tables 11-19 and 11-20. These tables are reproduced in the appendix to this report.

TABLE 7–2

SELECTED LIQUID FINANCIAL ASSETS HELD MAINLY BY INDIVIDUALS
(December 31)

	1935[c]		1945		1950		1955		1958		1962	
	$ millions	%	$ millions	%	$ millions	%	$ millions	%	$ millions	%	$ millions	%
Chartered Bank Personal Savings Deposits	1,300	74.5	2,635	73.3	4,176	63.8	5,633	55.5	6,844	54.5	7,932	45.8
Quebec Savings Bank Deposits	70	4.0	130	3.6	190	2.9	247	2.4	274	2.2	324	1.9
Caisses Populaires and Credit Union Shares and Deposits	9	0.5	135	3.8	288	4.4	598	5.9	919	7.3	1,516	8.7
Trust Company Deposits and Certificates	160	9.2	181	5.0	343	5.2	597	5.9	825	6.6	1,682	9.7
Mortgage Loan Company Deposits and Debentures	150	8.6	156	4.3	278	4.3	469	4.6	602	4.8	1,055	6.1
Deposits in Government Savings Institutions[a]	56	3.2	110	3.1	162	2.5	180	1.8	195	1.6	206	1.2
SUB TOTAL	1,745	100.0	3,347	93.1	5,437	83.1	7,724	76.0	9,659	76.9	12,715	73.3
Canada Savings Bonds[b]	nil	nil	248	6.9	1,104	16.9	2,433	24.0	2,895	23.1	4,620	26.7
TOTAL	1,745	100.0	3,595	100.0	6,541	100.0	10,157	100.0	12,554	100.0	17,335	100.0

[a]As at March 31 of the year shown. The Newfoundland Savings Bank was purchased by the Bank of Montreal on April 1, 1962, and the remaining 3 government institutions had deposits of $183 million on March 31, 1963.

[b]Includes War Savings Certificates in 1945 and 1950.

[c]Estimated.

banks or any other institution are either more willing or are in a better position than the rest of their competitors to provide such features, they can pay a correspondingly lower rate of interest than is offered on other institutional liabilities or savings bonds and still retain their overall competitive position.

In their efforts to attract business, the Canadian banks have in fact placed great emphasis not only on the liquidity and safety of their deposits but on the development of their branch systems. As a result we are as generously supplied with banking facilities as any country in the world. In 1930 there were 4,065 branches and sub-branches in Canada, one for every 2,511 people. Many branches were closed during the thirties, but in the post-war years there has been a substantial expansion and the banks now have 5,361 branches, an average of one for every 3,500 people. This represents a much higher density of banking facilities than in the United States where the 1960 average, including Savings Banks and the Savings and Loan Associations as well as commercial banks, was about 5,500 people for each office. The concentration of branches varies a good deal across the country, from a ratio of population to branches of 6,500 in Newfoundland to 2,600 in British Columbia.

Indeed, some would argue that far from suffering from a lack of bank branches, we have more than are needed to provide the community with adequate banking service. If this is true, the result can only be to increase the cost of bank services or to reduce the bank shareholders' return. Since the opening of unnecessary branches is a wasteful form of competition, the American authorities have attempted to control bank branching in a variety of ways. However, such controls

are always difficult to administer equitably, may result in some communities being poorly served, and might well impede healthy development by preventing efficient banks from expanding as rapidly as they might to provide better service to the public. We think it best to retain the branching freedom which has been part of our legislation, although we believe that there are tendencies in some areas to excessive expenditures on branching. The banks have clearly done a remarkable job in serving Canada's newer communities and their loss of competitive position cannot be ascribed to a shortage of outlets either in those or other centres. They might in future make more use of other forms of competition rather than adding to the density of branches in urban and suburban areas.

The banks attempt to provide a uniform service throughout the country, or at least an efficient service in all phases of banking for which there is a demand in a locality. Their success in doing so is important in the competition for funds since depositors know that the banks can give them the same standard of service no matter where they move in the country. Perhaps because of this policy, the banks observe uniform hours of business at most of their branches and do not in general compete with each other or with other institutions by fitting their office hours to local competitive situations. A recent move in this direction in response to competition from trust company branches in shopping centres was abandoned. Although the variation of office hours does no doubt raise personnel and administrative problems, it is surprising that banks have experimented with this possibility so much less than their competitors.

The rate paid on deposits is also a very important factor in attracting funds but the banks have tended to make less use of prices than of quality of service as a competitive weapon. In the case of corporate notice deposits in Canadian funds, the banks now compete more aggressively with other institutions on an interest rate basis although all banks pay a common rate. On personal savings deposits, however, the banks have not paid rates as high as those offered by their competitors and this has without question contributed to their relatively slow rate of growth. Although there is no precise relationship between the movement of funds and the spread of savings deposit and competing rates, there is evidence suggesting the force of interest rate competition. As an example, market rates and rates paid on such claims as trust and loan company liabilities rose quite sharply in 1959 while the banks' rate held steady at 2¾%.[6] In that year the share of personal savings deposits in the "market" represented by Table 7-2 declined more sharply than in previous years. In the following years, the growth rate of savings deposits remained low relative to other assets even though the rate gap narrowed. While a variety of factors were undoubtedly at work, it is probable that savers attracted from bank deposits to other assets by high rates in 1959 were prepared to stay with these newly discovered alternatives even when the yield advantage had dropped quite considerably. At the same time, rates on Canada Savings Bonds actually rose, and this no doubt added to the banks' competitive difficulties.

Another factor in the banks' loss of position in the savings field is that they offer only one type of interest-bearing deposit to individuals with balances of less than $25,000 and that they appear to be less flexible than some competing institutions in extending free chequing privileges. The banks have hesitated to incur the cost of raising the rate on the very large volume of savings deposits in order to attract the marginal funds which may be lost to others for interest rate reasons. However, the banks might minimize this difficulty by offering a wider range of deposits—some with chequing privileges and some without, some for short terms and some for long—in order to appeal more specifically to different parts of the market and give themselves the ability to raise rates on some deposits without having to do so on all. Indeed a willingness to replace the traditional Canadian banking practice of offering only chequable savings deposits with the American pattern of making available a wide and flexible

[6] See Charts 10-1 and 10-2.

range of instruments tailored to customers' requirements has also been important in explaining the success of competing institutions. In this as in other directions there seems to be a good deal of room for individual banks to break more sharply than they have thus far done with the tradition of uniform banking service. Some important steps have been taken, particularly in the field of term deposits, but in general the banks continue to move together in response to competitive pressures rather than to take individual initiative. An important contributing factor to this situation, and to the banks' inability to compete aggressively for funds when the general level of rates is high, has been the 6% ceiling. While we accept the view that the banks' competitive position suffers due to the ceiling, we think it important to recognize that restraints of this sort have not been the only cause of the banks' loss of position.

TRENDS IN THE BANKS' CANADIAN ASSETS

Changes in the structure of bank assets in recent years have been more dramatic and perhaps more significant for the future of the financial system than developments in the deposit business. As a result of war finance, more than half of bank funds in 1945 were invested in Government of Canada securities and only 30% were in loans and non-Government investments. In the following years of return to a more normal asset structure, the latter assets increased very rapidly while the total of government securities and other liquid assets followed a much slower and somewhat uneven upward trend. The share of loans and non-government investments in the total thus rose from 30.5% in 1945 to 64.6% in 1956 and has fluctuated between 60% and 70% since then (Table 7-3 shows these developments in more detail).

The most important changes in bank lending have occurred in business loans and in the extent to which banks have become lenders to individuals. As the table indicates, the growth of business lending has been somewhat slower in recent years than it was in the first decade after the war and businesses' share in the total of bank lending to the various sectors of the economy dropped from 57% at the end of 1956 to 52% six years later. Business demands for credit have remained fairly strong despite a reduced rate of economic growth and improvements in inventory control, but other forms of lending have expanded more rapidly, and the development of competing sources of funds for larger borrowers has altered the position of banks.

A market in short-term instruments has developed and a variety of larger borrowers have met a sizable share of their needs for short-term finance in this market rather than by borrowing from the banks. The sales finance companies, which played a major role in developing this market, turned to it first in 1951 when the banks were asked to restrict loans to them.[7] They have remained in it, both because they have frequently been able to borrow for less than bank lending rates and because there have been sharp reductions in their bank lines of credit in periods of monetary restraint. The same forces have led other large borrowers to enter the short-term market, more because of interest rate differentials than because of severe pressure on credit lines. Grain dealers, business firms, provincial and municipal governments have all made use of this relatively new alternative to bank accommodation. In a related but rather special field, investment dealers have borrowed increasingly from other financial institutions and ordinary corporations as an alternative to chartered bank call and day loans. These lenders, misleadingly called "country banks", have on occasion employed more than $400 million in this particular corner of the money market.

Sales finance companies have had as much as $500 million in short-term notes outstanding in Canada and some provincial and municipal governments have also entered the market. Borrowing by non-financial corporations has risen from very small beginnings a decade ago to over $300 million issued by about 50 borrowers in 1963. A survey which we conducted indicates that the

[7] Submission of Industrial Acceptance Corporation, para. 85.

TABLE 7–3

DISTRIBUTION OF CHARTERED BANK CANADIAN ASSETS[a]

(December 31st)

——	1945	1950	1956	1959	1962	Changes from 1945 to 1962
	(Percent distribution)					$ millions
Cash	11.6	10.4	8.6	7.9	8.0	478
Day loans and treasury bills	2.9	1.7	7.9	8.9	9.8	1,250
Government of Canada bonds	52.6	37.9	16.2	15.2	15.5	−861
Call loans	4.3	1.7	1.5	1.2	1.3	− 62
Net foreign assets	−1.8	−0.4	1.1	0.2	−0.6	22
SUB TOTAL	69.5	51.3	35.4	33.3	34.1	827
Less Liquid Assets	30.5	48.7	64.6	66.7	65.9	7,747
TOTAL ASSETS	100.0	100.0	100.0	100.0	100.0	8,575
	(Percent distribution of loans and other less liquid assets)					$ millions
Lending to:						
Businesses—						
Loans[b]	43.3	43.6	48.8	45.5	47.6	3,769
Securities	6.5	10.6	7.7	6.4	4.8	340
TOTAL	49.8	54.2	56.5	51.9	52.4	4,109
Persons—						
Loans	14.9	15.8	14.3	15.6	19.1	1,555
Mortgages	—	—	7.4	12.1	9.6	921
TOTAL	14.9	15.8	21.7	27.6	28.8	2,476
Agriculture—						
Farmers	4.3	6.4	5.4	4.9	5.8	478
Grain Dealers	5.8	4.2	5.6	5.4	3.3	206
TOTAL	10.2	10.6	10.9	10.3	9.1	684
Provinces—						
Loans	2.4	1.9	1.4	0.5	0.3	− 15
Securities	16.5	10.2	4.0	4.3	4.3	110
TOTAL	18.9	12.1	5.5	4.8	4.6	95
Municipalities—						
Loans	1.2	2.2	2.7	2.9	2.6	223
Securities	5.1	5.1	2.8	2.5	2.6	159
	6.2	7.3	5.4	5.4	5.2	382
SUB TOTAL	100.0	100.0	100.0	100.0	100.0	7,747

[a]Including the net position in foreign currency assets.

[b]Includes a relatively small amount of lending to religious, educational and similar institutions.

increases in corporate paper outstanding were concentrated in 1958 and in the period since the end of 1959: corporations appear to have turned to this market late in periods of credit restraint and in the following periods when market rates fall well below the less flexible lending rates charged by chartered banks.[8] The survey also gives dramatic evidence of the extent to which large corporations have substituted market for bank borrowing: from the end of 1957 to mid-1963 Canadian corporate paper outstanding rose from $24 million to $307 million while reported bank borrowing by the same companies declined from $356 million to $230 million.[9] During the same period, all chartered bank business loans rose $1,310 million, but the increase in loans under authorizations of $1 million or more was only $122 million.

It is clear that the banks have been faced with stiff competition for their larger business accounts. Future developments will depend on the banks' willingness to cut their rates to these customers in order to hold them, the ability and desire of borrowers to issue more short-term paper, and the readiness of lenders to take up paper issued by smaller and less familiar borrowers at relatively low rates. It is interesting that the banks are now prepared to lend stature to paper issued by such borrowers by "accepting" it in return for a fee. The Bank of Canada has actively fostered this recent development, just as it contributed significantly to the earlier growth of the money market. To the extent that an acceptance market does develop in Canada, banks will in effect be assisting borrowers, in return for a fee and with official encouragement, to meet some of their needs outside the banking system.

In spite of new competitive pressures in their traditional stronghold, the banks have continued to concentrate their attention on short-term business lending and have not moved aggressively into longer-term lending. A number of reasons may be adduced for this reluctance to reach into an area which would seem attractive to the banks. The banks made it clear to us that they do not believe term lending to be a completely inappropriate use for a portion of bank funds, but that they do place a priority on short-term "self-liquidating" finance. This is partly because of the demand nature of their liabilities, even though in normal circumstances any losses of cash are not expected to be large or permanent, partly because of banking tradition, and partly because short-term lending is believed on the whole to be the most profitable use of bank funds. Moreover, the Bank of Canada has on occasion reinforced these views by requesting that term loans be particularly restricted in periods of credit restraint. The banks have avoided heavy term lending in other periods because of their belief that they can do the most good for the most people by looking after their customers' short-term needs. They believe they would be unable to do so, especially when funds became scarce, if they were dramatically to alter the character of their lending. The 6% maximum on loan rates has also undoubtedly inhibited a move into term loans, for the banks have not always been able to charge rates commensurate with the risk of longer-term lending. Finally, the general prohibition on mortgage lending has been a factor by precluding the banks from taking the most appropriate collateral for term loans, particularly loans to smaller borrowers lacking other acceptable security.

Whatever the reasons may be, a survey prepared for us by the banks indicates that on September 30, 1962 only $575 million, or 13%, of business loans outstanding had an original term of more than one year. This figure understates the amount of term lending because many loans granted under normal lines of credit are in fact used for capital purposes extending over a number of years. Indeed, formal term loans which call for a contractual repayment each year may be repaid more rapidly than some "operating credits" which in fact become a part of the borrower's permanent capital. Despite the understatement

[8] This pattern emerged in a period of rapid growth in the market when new borrowers were entering it for the first time. A somewhat different cyclical pattern may emerge now that these borrowers are established users of the market. See the appendix volume for details of the corporate paper survey. Chart 1 in Chapter 11 compares bank prime rate and short-term rates.

[9] The decline in these bank loans was in fact even larger since the survey information is not complete for earlier years.

in the survey, it is clear that term lending is a smaller part of business loans than in the United States where the proportion was 38% in 1957 and may well be higher by now. We agree with the banks that "a portion of a bank's deposit funds may, subject to proper safeguards, be made available for long-term investment"[10] and think it desirable from the point of view of the banks as well as of the smaller businesses which might benefit that banks continue to lend more freely on an explicit term basis. To the extent that the 6% ceiling and the present law on mortgage collateral stand in the way of more such developments they inhibit a desirable adaptation of the financial system to changing needs.

A number of steps designed to promote particular types of term lending by guaranteeing such loans have been taken by the government. The most important of these in terms of the volume of funds made available, excepting of course N.H.A. mortgages, have been Farm Improvement Loans and Home Improvement Loans. More recently the guarantee has been extended to small businesses under the Small Businesses Loans Act. Under the federal legislation, banks are guaranteed against losses on a proportion of loans granted up to some maximum amount of loans established in the different Acts. The object is to induce them to grant credit to particular borrowers, although in some cases it may merely change the form of credit which would have been extended in any event. Lending rates are set in the legislation or by regulation and tend to be lower than the borrowers might obtain under free market conditions. Some of the guarantees have served a useful purpose by inducing banks to take up new areas of business which unfamiliarity and fear of risks had inhibited them from entering. However once the banks had learned, as has been true in most cases, that losses are no higher than on other lending, it is less certain that the guarantees serve a useful purpose as a continuing feature of the financial system. Indeed, as interest rates rise the guaranteed lending rates, which are usually very inflexible, remain artificially low with the result that the legislation reduces the incentive to lend in the directions it is intended to favour. Interest rates on guaranteed loans should, we believe, be set initially at reasonable levels and move up and down with other lending rates. We further recommend that where guarantees are introduced they should be specifically intended as temporary measures to open up new credit channels and should be made available to other lending institutions with suitable facilities as well as to banks.[11]

Section 88 and related parts of the Bank Act are designed to assist businesses and farmers in obtaining short-term banking accommodation. By the same token, these sections increase the attractiveness of short-term lending to the banks by enabling them to acquire a prior claim on the goods pledged. In November 1961, a survey conducted by the banks showed that security under sections 82, 86 and 88 had been taken for $1.1 billion of loans, compared to a total of about $3 billion of loans outstanding to the same classes of borrower at the end of the year. The pledge sections are very important to some types of borrower, while because of the nature of their business they are used little or not at all by others. In a number of industries something like one-half by value of loans appear to carry this class of security but it is relatively unimportant, for example, in lending to the transportation equipment, petroleum refining or chemical industries where the units tend to be very large. Such borrowers as farmers, grain dealers, lumber operators and the clothing industry make particularly heavy use of section 88. It is impossible to estimate what share of these loans would not have been made in the absence of the special provisions of the Act, but there is no doubt of their importance to the banks and a great many of their customers. At present the banks alone have access to the prior claim features of this part of the Bank Act: we will return later to the possibility of extending them to other financial institutions.

In addition to granting loans to businesses and to provincial and municipal governments, the

[10] CBA Submission, para. 127.

[11] See also the discussion in Chapter 12.

banks invest part of their funds in securities. However, the banks think of themselves primarily as lending rather than investing institutions and are organized to give emphasis to short-term loans. When demand is adequate, banks usually invest available funds in loans rather than in federal government securities because of the nature of their business, and because it is thought more likely to attract deposits. Yield considerations are, of course, also important but on occasion the banks' fundamental preference for loans will lead them to employ their resources in this way even when the return on securities is higher. Federal government securities in excess of liquidity needs are thus regarded as a form of residual investment. Securities of businesses and of provincial and municipal governments are usually acquired by banks at the time of original issue and held until maturity, although they are sometimes purchased and sold in the secondary market. Thus for the bank and the borrower these securities are in many respects not a distinct type of asset but an alternative form of loan to which the 6% ceiling does not apply.

The banks' holdings of provincial, municipal and corporate securities, which amounted to $1.1 billion at the end of 1962, have grown more slowly than loans in recent years. Investment in securities represented a very small share of bank credit to business, about one-half of lending to municipalities and the bulk of bank lending to provinces. The shift by larger businesses to cheaper market financing, the efforts made by banks to persuade these customers to move into the market rather than borrow through issues placed directly with the banks in periods of tight money, and restrictions on direct security purchases along with other term lending have all contributed to the slower growth of bank holdings of corporate securities. In the case of provincial securities, the strong competing claims for bank funds and the development of longer-term investing institutions have led the provincial authorities to tailor their issues more to the requirements of other lenders. Bank holdings of municipal securities are about the same proportion of assets as they were six years ago, but the banks suggested that the trend toward longer maturities of municipal issues has made them less attractive as a bank investment since their investment choices are influenced by the same preference for short-term investments which marks their loan policy. A classification prepared for us by the banks indicates that in mid-1962 almost three-quarters of their holdings of bonds other than those of the federal government were due to mature within five years. Equity holdings of banks are relatively small because of the fixed-dollar nature of banks' liabilities, the very different risks and skills involved in investing in common shares, and the banks' experience in the area of fixed-value lending.

Banks also participate in the security business through underwriting many provincial and municipal issues. Their relationships with customers as loan grantor, underwriter and as purchaser of securities are closely interconnected. For instance, a bank may extend finance to a municipality, then assist in the underwriting of an issue to pay down the loan, and purchase a block of the shorter maturities. Banks also execute customer orders for securities but are reluctant to get into the investment advisory field because of the special skills involved and the difficulties it poses for customer relations. We might, however, see a tendency for the banks to use their specialized head-office security departments to provide more of this service in future.

One of the most dramatic shifts which has occurred in bank assets has been the growth of mortgage and other loans to individuals. Since 1945 chartered bank lending to individuals has jumped from $269 million to $2,573 million, accounting for 32% of the increase in the banks' loans and holdings of non-government securities. Mortgages under the National Housing Act climbed to almost $1 billion between 1954, when banks were first permitted to acquire them, and 1959. At that time the N.H.A. rate went above the 6% bank lending rate ceiling and some banks thought further mortgage lending would be illegal and in any case all banks were under pressure to control their lending and stopped taking on

new mortgages. Their mortgage holdings have slipped a little below the peak reached in 1959 but their lending experience has been favourable and they will doubtless be confident lenders in this field again when developments allow it.

Beginning in 1958 the banks began to develop their personal instalment lending very vigorously. While only one bank had previously been active in this business, all but one now offer instalment loans, normally repayable in three years or less, and most of them carrying a gross interest and service charge varying from 9¼% to 11¼%. The rate structures differ among banks, but in most cases the rates are higher for longer-term loans. On the other hand, only one bank varies its rates with the size of the loan, charging higher rates for small amounts. The banks have taken the view that the charges under these plans do not involve a breach of Section 91 of the Bank Act and this interpretation has not been challenged by the authorities.[12] Without expressing a view on the point of law, we agree that large-scale personal lending by the banks has introduced a desirable new element of competition in this market. The banks' share of the consumer loan market has now increased to the point where they are the largest lenders in the field. They are committed to this relatively new line of business, are well established and organized to continue it, and there is every reason to believe that they will expand it further.

As in the case of rates on deposits, minimum rates to be charged on most types of loans are established by agreement among the banks. These rates are set out in a common schedule used by the banks, the outstanding exceptions being personal instalment loans and loans made in foreign currencies on which there is full price competition among the banks. "Prime rate", the rate charged to the most credit-worthy business borrowers, is the key rate in the structure: most other rates are normally adjusted when prime rate moves and do not frequently move at other times, although rates on call loans are kept fairly close to market rates. It has not been the practice of Canadian banks to alter prime rate frequently, and one of our main criticisms of the practice of agreeing on interest rates is that it reduces their flexibility in response to changing conditions in financial markets. Even in the absence of rate agreements, loan charges would undoubtedly tend towards uniformity, as in many other banking systems, but we would expect them to move more frequently, to "fan out" more from the prime rates as they do in the United States,[13] and to vary with increased sensitivity to market forces.

At present, there is a strictly limited amount of price competition among banks in their lending business. Banks may differ in their view of whether a particular customer merits prime rate or not, but their rates are subject to agreed minimum levels. Price competition has been further restricted in periods of credit restraint by agreements among the banks to the effect that no bank will take over an account from another by offering a better rate or a larger line of credit. The "no-raiding" pacts have not survived for long but while they do the borrowers' main negotiating weapon, the threat to go to another bank, is effectively spiked. It has been argued in favour of this sort of agreement that it is an essential part of a policy to restrict bank loans since banks will be less willing to control credit if they run the danger of losing good customers. In circumstances of credit restraint when banks are under liquidity pressure, however, no bank will be receptive to new accounts at the expense of its established customers. While we would not be opposed to such "no-raiding" agreements in exceptional circumstances if they were to add to the speed with which loan policy altered and were also expressly requested by the Bank of Canada, frequent resort to agreements could produce lasting damage to the efficiency of the financial system.

In the absence of much price competition among the banks, competition for lending business centres on the amount which banks are

[12] It is evident from the tenor of discussion before the Banking and Commerce Committee in 1954 and from the fact that the Bank Act was amended to permit the taking of chattel mortgages that the banks were encouraged to develop their personal loan plans.

[13] The 6% ceiling is an important additional reason for the narrow range of bank lending rates.

prepared to lend to particular customers, on the term of loans and on the type of security called for; here there is every indication of active competitive conditions. Moreover, in lending as in deposit business, banks rely heavily on quality of service to attract customers. All the factors already mentioned, branch locations, uniformity of service, special services of one kind and another, are brought to play in their efforts to obtain and keep borrowing accounts. As in deposit competition, these efforts may at times lead to an undesirable emphasis on size and prestige.

In September 1962, the banks collectively decided to put an end to the practice of overdraft lending. While most lending has been on the basis of promissory notes, overdraft lending has been in existence since beginnings of Canadian banking and is still the main form of lending in some banking systems, although not in the United States. The banks are opposed to overdrafts because they find it difficult to control such loans in cases where borrowers draw on their accounts without making prior credit arrangements, because it reduces the effective return on lending and because their branch procedures are such that overdrawn accounts may involve considerable extra work for the manager. It is also their strongly-held view that it is sounder business practice for the customer to arrange his line of credit in advance and to sign notes for the amount he wishes to borrow. However, some customers may find overdraft borrowing more convenient, and when a line of credit is established in advance it should not involve any lack of control by the banks nor be less predictable than other forms of borrowing. The extra costs of such a system have traditionally been recouped by a slightly higher lending rate and there is no reason why modern bookkeeping systems cannot be adapted to it, especially if overdraft borrowing were to be kept strictly within established credit lines. Under any system of lending, bank officials will still have to decide whether the customer's credit standing and other factors justify honouring cheques for which prior arrangements have not been made, although we agree that failure to make such arrangements is an undesirable practice from the standpoint of borrower and banker alike. While no one has demonstrated to us that overdraft borrowing under prearranged lines is impractical, the bankers appear to believe that it would be difficult to prevent this from degenerating into widespread unarranged overdraft borrowing. Our recommendations about agreements among banks will be discussed in Chapter 18.

To a limited extent, the banks try to build up expert knowledge of particular industries in order to attract business, the most outstanding examples being the banks' personal loan departments and the oil and gas departments established by some banks. In other cases where there is no specialized department in a bank, individual credit supervisors are responsible for larger loans to particular industries on which they are expected to be more than usually well informed. Canadian banks do not, however, emulate the American banks by making a point of developing business on the basis of their expert and intimate knowledge in particular fields, preferring to train and organize their staffs towards a broad general experience. Although it is not an easy matter to graft functional lending and business development departments onto a national branch organization, there might be advantages in the banks devoting more attention to industrial and regional specialization and to the development of varied lending techniques which might better serve the particular needs of different industries and local areas.

A quite striking pattern emerges from this review of the recent development of Canadian banking. Chartered banks are directing an increasing share of their resources to small business and individual borrowers—while the larger borrowers—businesses, governments, financial institutions such as sales finance companies and investment dealers—have turned increasingly to other, cheaper sources of funds. The banks indeed have been less anxious to compete for the large borrowers than for large depositors because they have found attractive higher-yielding outlets such as personal loans in which to employ their funds. The banks will probably continue to evolve grad-

ually in this direction of giving more emphasis to lending to small borrowers of all types since their large branch networks place them in a strong position to cater to these customers. One of the main impediments in recent years to a desirable move in the direction of meeting the needs of smaller business borrowers for longer-term credit as well as the traditional working funds has been the maximum permitted loan rate. Our financial system has developed to the point where a measure intended to protect smaller borrowers now works against them by denying them access to bank funds and sending them elsewhere to borrow at interest rates which are often well in excess of the rates which banks would charge. In the area of personal lending, the main impediment to bank activity is the mortgage prohibition, which keeps them out of the conventional residential market.

One should not over-dramatize either what has happened to bank lending or what might happen in the future. We have witnessed a profound change in the banks' attitude towards longer-term lending and the smaller borrower just as we have seen a change in attitude towards term deposits and competition generally. Many of these changes have been the result of competitive pressure originating elsewhere in the financial system, but some have had their roots within the banks themselves. Yet the banks have by no stretch of the imagination deserted their big borrowing customers in the move to new and greener fields. Tradition, the prestige of big accounts, and the weight of experience and of established practices are strong. Thus if the present legal limitations were removed we would not expect the banks to alter the character of their business overnight.

CHARTERED BANK RESPONSE TO MONETARY POLICY

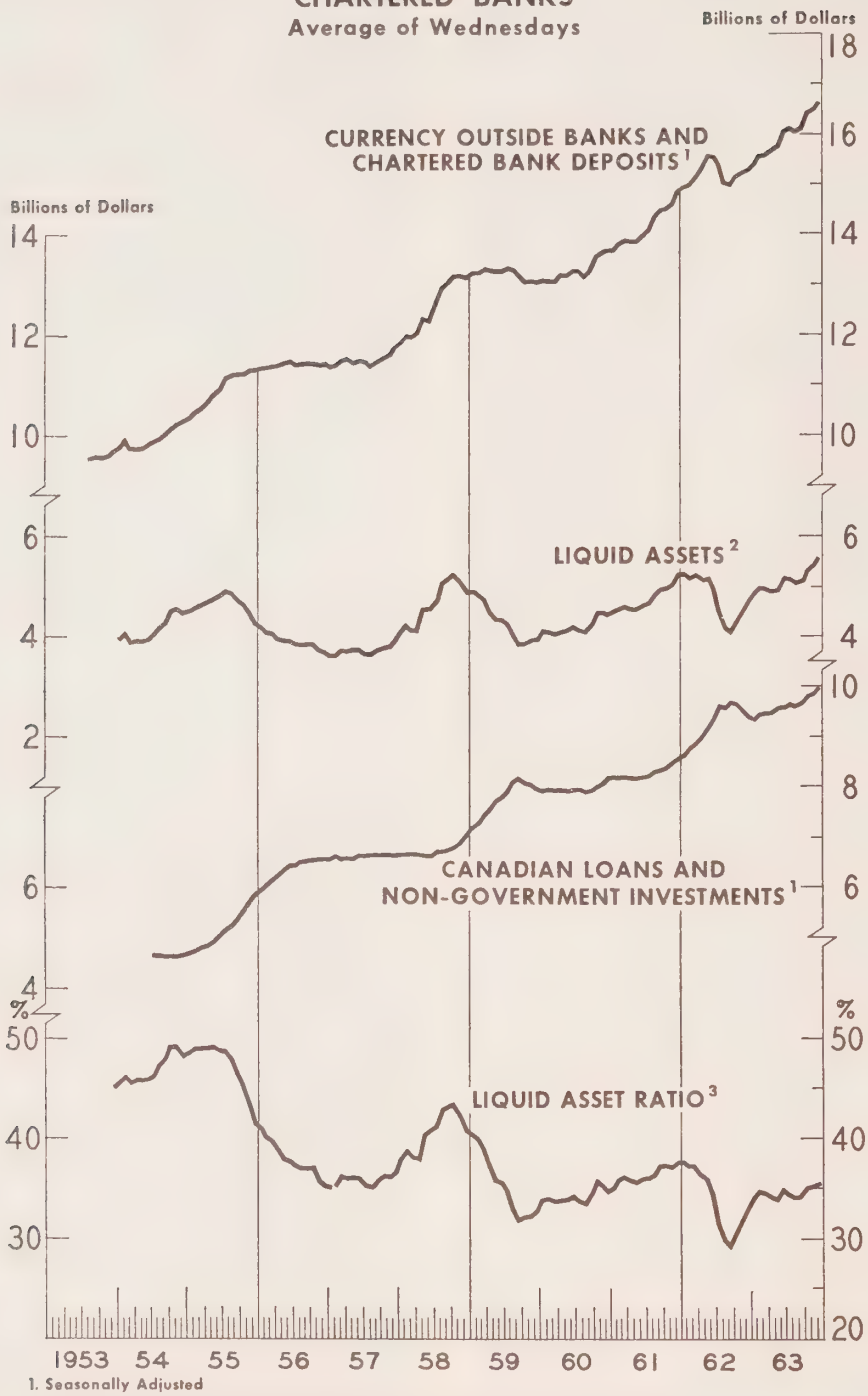
In addition to their loans and investments in provincial, municipal and corporate securities the banks hold a fluctuating but always substantial part of their assets in more liquid form. The law now obliges them to hold cash equal to at least 8% of their Canadian dollar deposits although the Bank of Canada has power to raise the requirement in stages to an upper limit of 12%, and by agreement with the Bank of Canada the banks also hold a "secondary reserve" of sufficient additional cash, treasury bills and day-to-day loans to bring their combined holding of these three types of assets to a minimum of 15%. While these are in a sense the most liquid assets they are of limited use as a reserve of liquidity since they must be maintained at these levels each month and cannot be used to meet the calls of customers or settlements with other banks for the month as a whole. The true liquidity reserve which banks hold to ensure their ability to meet cash drains, and to take advantage of attractive lending opportunities when they arise, consists mainly of short-term assets which earn interest yet can readily be turned into cash if needed. These take the form of additional bills and day loans, call loans to investment dealers and brokers, funds invested in foreign currencies which may be drawn down as need arises, and, most important of all, the portfolio of Government of Canada bonds.

The manner in which the Bank of Canada is able to influence the level of bank assets and deposits by varying the available supply of cash reserves was described in the previous chapter. The banks are led to increase their assets when cash reserves are plentiful, and their action tends to increase the availability of credit in the economy and thus lower its cost. Conversely, when cash reserves are made less plentiful relative to the banks' needs they are induced to limit their purchases of assets or to sell assets with the result that interest rates tend to rise and credit conditions tighten. The banks, however, are not in practice able to vary their holdings of loans and non-government securities from day to day or week to week in response to action by the central bank. The trend of these assets is determined by the underlying state of demand for funds in the economy and by bank policies which are altered relatively infrequently. The banks adjust their positions in the short run by varying their holdings of liquid assets—assets which are readily marketable and are subject to immediate head office control. Central bank control of the banks over short

Chart 7-1

CHARTERED BANKS

Average of Wednesdays



1. Seasonally Adjusted
2. Cash, Government of Canada securities, day-to-day and call loans, net foreign assets
3. Liquid assets as % of total Canadian and net foreign assets

periods consists therefore in altering the willingness and ability of banks to hold liquid assets, that is to say in influencing their activity in the money and Government bond markets.

The marked cyclical pattern in the recent behaviour of bank assets stands out in the accompanying chart showing Canadian deposits and the broad division of bank assets between the more liquid assets and their loans, mortgages and non-Government securities. An expansionary monetary policy puts the banks in a position to expand their assets at a time when loan demand is usually weak and bank holdings of bonds and other liquid assets rise. As private loan demand subsequently strengthens and the banks' increased liquidity leads to a greater willingness to lend, their loan portfolios begin to rise rapidly. The authorities may supply cash sufficient to permit banks to hold, or even add to, their liquid assets while meeting the loan demand, but if this degree of credit ease is thought to pose a danger of excessive expansion of demand in the economy, cash pressure will be brought to bear. Banks then begin selling off their liquid assets to meet the loan demand within a relatively stable total of bank assets until the reduction in their liquidity and increasing losses on security sales, reinforced perhaps by injunctions from the authorities, lead the banks to tighten up their lending policy and increase their lending charges. Under the influence of restraint on the supply of bank credit, rising interest rates on bank loans, and ultimately of weakening demand for credit as the business cycle matures, the increase in bank loans slows or comes to a stop. In effect the Bank of Canada influences bank lending policy at any given level of interest rates by altering the consequences for bank liquidity of meeting current and expected loan demand, sometimes ensuring that banks are able to maintain relatively high liquidity and follow a free lending policy and at other times obliging the banks to run their liquidity down if they wish to increase their loans.

The share of liquid assets—defined to include cash, day and call loans, government securities and net foreign assets—in total Canadian assets has declined since World War II as banks readjusted to peacetime conditions. It has also moved lower in each successive cycle of credit policy. It should be pointed out that not all these so-called liquid assets are readily realizable—for example, some longer-term government securities, and call loans which are not in practice callable, are included. On the other hand, the maturing of securities other than those of the federal government and the regular repayment of loans represent an important element of liquidity in the other assets.[14] In any event, in 1956-57 this liquidity ratio reached a minimum of about 35%, in 1959 it was driven down to 32% at the time that loans stopped rising, and in the rather unusual circumstances of 1962 the liquidity ratio of the banks reached a low point of about 29%. The banks became accustomed to working to lower levels of liquidity in each bout of strong loan demand and restrictive monetary policy but whenever they felt their liquidity to be approaching the minimum they were prepared for the time being to accept they adopted more restrictive loan policies.

When pressure is brought to bear on the banks their first response is to liquidate some of their holdings of day loans and treasury bills and perhaps to draw to a limited extent on their foreign positions. If the pressure persists, however, they are soon driven into the main liquidity reserve, the Government of Canada bond portfolio. In 1955-57 the banks ran off or sold $1.6 billion of bonds, in 1958-59 the liquidation amounted to $1.1 billion and in 1962 to about $800 million; these reductions represented 49%, 37% and 30% of the portfolios held at the beginning of each round of monetary restraint. In the course of these sales the banks incur capital losses which become more severe as the process continues, but these losses do not by themselves deter banks from continuing to switch into loans, partly because much of the increased lending may come under credits already authorized and also because banks have tended to shorten their government bond holdings in

[14] The banks might improve their true liquidity if they were to offer dealers and brokers truly "callable" loans at better rates than those applying to less callable accommodation.

anticipation of future restraint and now keep a sizable proportion of their portfolios fairly evenly distributed in under five-year maturities. A more important deterrent is without question uneasiness about the declining liquidity ratio and a view, imprecise but powerful nonetheless, that the drain on liquidity must be halted.

The Bank of Canada has defended the 1956 secondary reserve agreement referred to earlier on the grounds that it leads to a smoother response by banks to changes in monetary policy, implying that in a period of restraint the banks must carry their liquidity adjustment into the bond portfolio sooner than they otherwise would and, since part of their "liquid" position is in fact frozen, must similarly make earlier adjustments in loan policy. The agreement, in other words, amounts to a specific intervention in the freedom of part of the market with the object of altering its response to central bank action. We have no dogmatic objection to this sort of intervention if it significantly improves the central bank's ability to carry out its responsibilities and its advantages to the economy as a whole outweigh its disadvantages, but we find it difficult to believe that the secondary reserve agreement in its present form is much of a help. The bond portfolio provides the main reserve on which banks draw to meet loan demand when their resources are not growing adequately, and the significant liquid position for purposes of influencing the banks therefore includes bonds as well as treasury bills and day loans. As long as the banks are unwilling to let their overall liquidity fall below 15%—and their current thinking seems to put the practical minimum in the range of 25-30%—it is difficult to believe that their willingness to move from liquid assets into loans is limited to any significant degree by the fact that a portion of the liquid assets must always be held in a particular form. However, since the use of such balance sheet ratios has wider implications we will return to this question in the latter part of the report.

Internal factors are also involved in changes in chartered bank lending policy. In order to understand how central bank action on bank liquidity is translated into actual lending decisions, it is important to appreciate the way in which banks organize this side of their business, the factors affecting the timing and nature of changes in loan policy, and the degree to which loans actually respond to changes in a bank's policy.

A good deal of the responsibility for credit decisions is delegated by head offices to branch managers and regional supervisory offices. The following table classifying loans by the size of their lines of credit gives an indication of the division of credit authority. Under their "discretionary limits", most of which are for $10,000 or less, the branch managers make final decisions on well over 90% of loan applications covering at least one-quarter of the dollar amount of loans. Regional supervisors or assistant general managers outside head office are responsible for most accounts lying between $10,000 and $100,000 and an increasing number of them have authority to approve much larger applications. The remaining large applications—which account for about ½ of 1% of the accounts but for a substantial share of the 50% of loans which were made under authorizations of $100,000 or more—are passed on to senior officials in head office.

SIZE CLASSIFICATION OF LOAN ACCOUNTS
SEPTEMBER 30, 1962

	Number of Accounts		Outstanding Amounts	
		%	$ Millions	%
Under authorizations of:				
Less than $10,000	1,992,417	96.3	2,175	30.9
$10,000 to $100,000	63,547	3.1	1,362	19.4
$100,000 or more	12,141	0.6	3,497	49.7
All Accounts	2,068,105	100.0	7,033	100.0

Credit policy is communicated to the branches and regional offices by means of circulars issued as need arises. These circulars must cover all aspects of the banks' lending policy because branch managers deal with nearly all borrowing customers whether or not the amounts in question fall within their discretionary limits.

Most bank loans are granted under lines of credit negotiated annually with customers which normally entitle them to borrow up to the established limit without further authorization. In the case of borrowers with varying seasonal requirements for accommodation, the line will be large enough to cover their highest expected needs in the coming year but it will be understood on both sides that the maximum amount will only be called for at the seasonal peak. Indeed a bank looks for a "healthy fluctuation" and reduction of a loan to a low level each year as one of the marks of a sound commercial account. Under Canadian practice the customer seldom pays a fee for the unused portion of his line of credit and the banks are not absolutely committed to lend the full amount. The line is strictly speaking an indication of the amount which a borrower may expect if conditions do not change, and funds may be refused if the borrowers' circumstances have altered for the worse or if a change in monetary policy leads to a restrictive loan policy. In practice, however, the banks feel an obligation to meet their loan authorizations. Moreover, the fear that an unhappy borrower may well take his business elsewhere reinforces their desire to look after his needs under his existing line of credit.

For a variety of reasons no bank likes to make frequent changes in the lending instructions under which its managers operate. In the first place it would be difficult for managers to develop self-confidence and independent powers of judgment if they were subjected to continuous minor changes in their instructions. It is difficult in any case to convey the sense of such minor policy changes in written circulars with any confidence that the managers will respond just as head office wishes, although we were told that some branch managers are able to get the "feel" of slight changes in bank policy by the attitude of supervisors to credit applications. Since frequent circulars are likely to lead to confusion and indecision throughout the branch system, the banks hesitate to alter course towards a restrictive policy until they are fairly confident that the trends in loans and total assets will lead them into serious liquidity difficulties. This points up the second reason for some hesitation on the part of banks. The future is always uncertain: the outlook for bank loans is not easy to forecast and the central bank's intentions may not be entirely clear. In this situation, a bank is tempted to delay a move to restrain its loans until it becomes clearly necessary. The President of the Canadian Bankers' Association stated in evidence before us that the banks do not alter loan policy until they "definitely detect a major change".[15] Finally each bank's reluctance to upset its own organization and to turn away profitable lending business unnecessarily is reinforced by a natural fear of its competitors. The bank which first moves to a strongly restrictive policy stands to lose business to others and a bank is usually unwilling to restrain loans sharply until circumstances leave it no alternative.

Either at the suggestion of the Bank of Canada or as a result of consultation among themselves, the banks have in each period of monetary restraint adopted a common loan policy and informed branches of the change at about the same time. The Bank of Canada can shorten the delay between the onset of monetary restraint and a move to effective restriction on loans either by pursuing its policies with unmistakable vigour or by bringing the banks together for discussions out of which a generally accepted policy emerges. A combination of the two methods is likely to bring the quickest results, as events in 1962 showed. In November 1955, the banks were called together very shortly after restraint on total bank assets began, and the first restrictive circulars went out almost immediately. However, central bank policy was not sufficiently restrictive to bring about an early or complete stop to loan increases. In 1959, on the other hand, the Bank of Canada restrained total bank assets with determination but did not take the lead in discussion with the banks and a full six months elapsed between the end of increases in the money supply at the end of 1958 and the banks' decision in May 1959 to adopt a more stringent lending policy. Loan increases came to a halt fairly

[15] Transcript, page 8112.

shortly thereafter, in part because the banks' liquidity positions were by then seriously impaired.

Once the banks are brought to an alteration of course in their lending policy, they issue circulars urging managers to scrutinize credit applications more carefully and to do their best to persuade borrowers to keep their calls on lines of credit to a minimum. In the recent bouts of restraint the managers were also told to follow a freer policy in dealing with small accounts—personal borrowers and other accounts with lines of credit below $100,000. In addition to quite general lines of policy such as these, the banks have entered into specific agreements to restrict certain types of lending, sometimes at the suggestion of the Bank of Canada. They have, for instance, agreed not to grant term loans or buy corporate securities from the issuer in excess of $1,000,000, or at times some lower figure. They have agreed not to permit increases in larger finance company lines of credit and have refrained from granting loans for speculation in securities or real estate. As the periods of restraint in 1956-57 and 1959 progressed, additional circulars tended to increase the range of business covered by specific instructions and to urge managers to make more strenuous efforts to bring loans under control. The early requests that increases in lines of credit should be resisted became firm instructions not to permit increases. Some of these circulars issued in the course of a period of restrictive loan policy reflect additional common policies adopted by the banks: for instance in the fall of 1956 the banks agreed to limit large sales finance company accounts to the highest level reached by their outstanding loans during the previous year. Others differ from bank to bank and reflect the particular circumstances of each bank and the views held by its management.

The amount of unused lines of credit influences the impact of a restrictive policy on individual borrowers and the ease with which banks can exercise effective control over their loans. Information on lines of credit of $100,000 and over is available quarterly and the banks have supplemented this for us by collecting data covering accounts with authorizations of $25,000 to $100,000 at September 30th 1962.

BUSINESS LOANS AT SEPTEMBER 30, 1962

—	Authorized Lines of Credit	Outstanding Loans	Share of Authorizations In Use
	$ millions	$ millions	%
Under $25,000	n.a.	743	n.a.
$25,000 to $50,000	376	299	79.5
$50,000 to $100,000	440	342	77.7
$100,000 to $1 million	2,260	1,400	61.9
$1 million to $5 million	1,809	871	48.1
$5 million and over	1,664	673	40.4
TOTAL: $25,000 and over	6,549	3,585	54.7

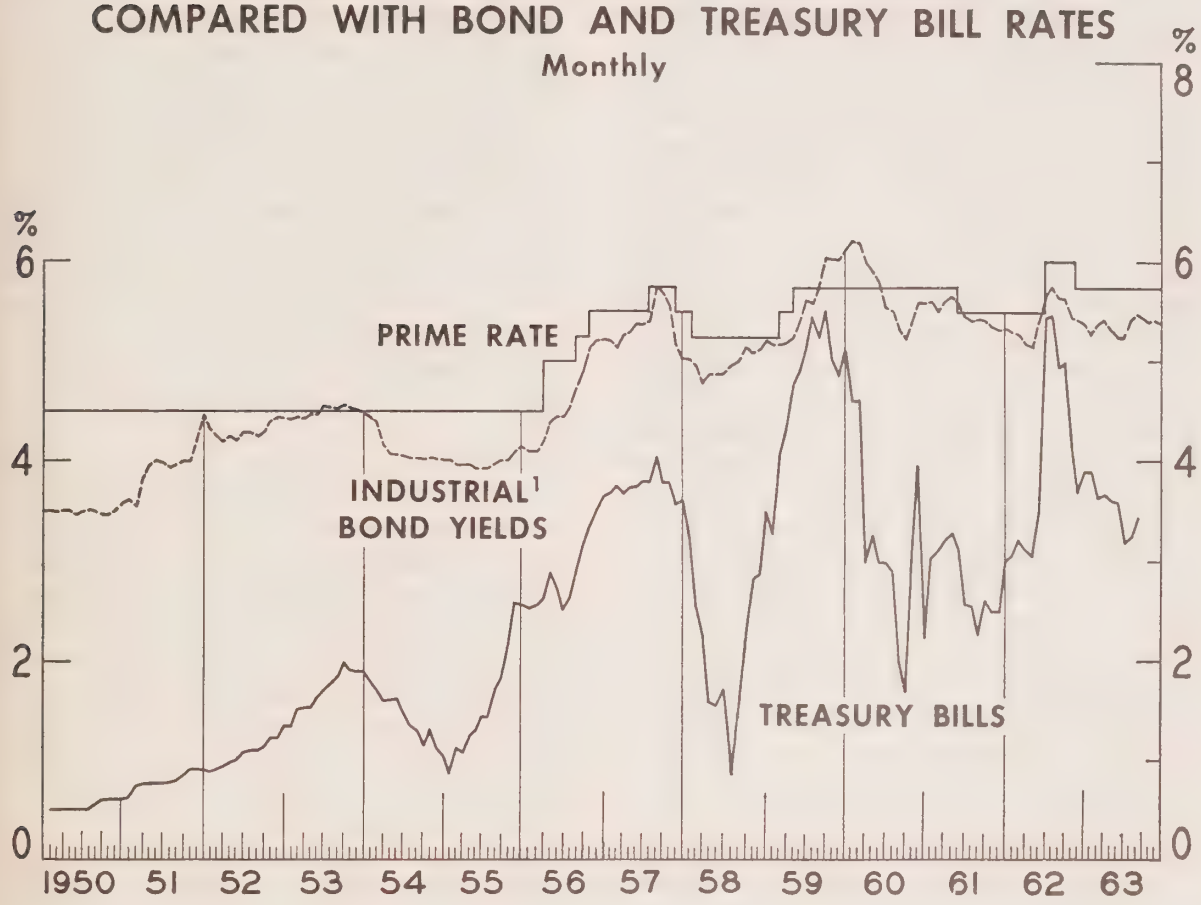
The relative positions of borrowers with different sizes of account at this date are probably fairly representative of the normal situation. Small accounts are much more fully borrowed than those with large authorizations, partly because many larger borrowers seek a line in excess of any possible needs as a symbol of prestige or to increase their ability to raise funds in the money market. Despite bank efforts to protect them in periods of tight money, smaller borrowers lack large unused credit lines. This, together with their comparative difficulty in finding alternative sources of finance, makes them more exposed than large firms when credit lines or borrowings are frozen. New or rapidly expanding ventures of all sizes are in the same position since banks are usually unreceptive to establishing or extending credit lines in periods of credit restraint.

It has been suggested that the banks should charge a fee for unused credit lines and that such "standby" fees would reduce the volume of unused credit lines, particularly of bigger firms, and thus contribute to easier control of bank lending. The banks have offered firm six-month lines of credit to sales finance companies in exchange for a fee but they have not been generally accepted. We can see no objection to the use of standby fees if they are agreeable to both parties but the resulting credit lines, although smaller, would be firm commitments to lend in any circumstances and would still have enough margin

Chart 7-2

CHARTERED BANK PRIME LENDING RATE COMPARED WITH BOND AND TREASURY BILL RATES

Monthly



1. McLeod, Young, Weir average

in them to be a source of difficulty. We are not therefore persuaded that the change would materially ease the problem of controlling loan increases. In any event, the banks would still have to rely on the co-operation of larger borrowers to refrain from using bank credit as much as on freezing lines of credit or attempting to curtail other borrowings at some maximum or average level of use.

Chartered bank lending rates have risen with the tightening of credit conditions on each occasion, although there has been a tendency for such increases to take place comparatively late in the day. From a level of 4½% at the end of 1955, prime rate rose to 5% in April 1956, 5¼% in August and 5½% in October where it held until a final increase to 5¾% in August 1957. In 1959 the rate was increased from 5¼% to 5¾% in March and April and in 1962 it moved up from 5½% to 6% in July. As shown on chart 7-2, the upward movement in bank lending rates has been part of the general tendency to higher levels of interest rates. The banks have not relied very heavily on higher lending rates to deter

borrowers, in part because the 6% interest rate ceiling has prevented them from doing so. However, the banks' traditional reluctance to use price competition and a fear of public reaction have probably been important contributory factors, especially in the earlier period when rates were well below the ceiling. The fact that their rates may not rise above 6% has in periods of high interest rates complicated their already difficult job of stemming the demand for loans by forcing them to rely almost exclusively on direct loan rationing. While it is hard to believe that banks would ever be willing or able to raise their rates to the point where cost alone would bring loan supply and demand into line, greater freedom to move rates with the tide would undoubtedly contribute to smoother and more equitable changes in credit conditions and remove the artificial incentive for borrowers to call on bank credit.

It is not possible to form precise views about the effect which changes in bank loan policy and interest rates have had on bank lending, for one cannot know how much of a slackening in loans is due to weaker demand and how much results from the banks' own efforts. The evidence makes it very clear, however, that major changes in the trend of bank lending cannot be accomplished overnight because of the difficulty of bringing large branch systems into line, because of the severe disruption of the affairs of borrowers which such a change would involve and the difficulty of refusing funds where lines of credit have already been granted, and because many borrowers try to take advantage of artificially favourable bank rates by pressing their demands for bank accommodation. While some minor changes in policy can be made quickly, especially as bank managements have become more accustomed to changes in monetary policy and where such changes involve matters directly under head office control, the time involved in bringing about major alterations is longer. It depends not only on loan demand, bank liquidity, and central bank action but on how seriously the banks and the business community view the situation. Thus in 1955 bank assets stopped rising in November, a change in loan policy was introduced in circulars issued in December and yet the total of loans and non-government investments continued to rise at an unchanged rate for six months or so and did not stop rising for a full year. On the next occasion, the rapid increase in bank assets had been arrested by October 1958, but the first credit circulars were only issued in May 1959 and lending continued to rise until September. Even in the emergency conditions of 1962 there was a good four months delay from the onset of restriction until loans stopped rising. The implication of delays between the adoption of a policy of monetary restraint by the authorities and a change in the trend of bank lending will be explored in our discussion of monetary policy later in the report.

THE BANKS' FOREIGN CURRENCY BUSINESS

Previous sections of this chapter have dealt almost exclusively with the domestic Canadian dollar business of the banks. The banks also conduct a foreign currency business, both in Canada and abroad, and this part of their operations has expanded very rapidly in recent years. Since 1954, the Canadian dollar assets of the banks have increased by about $5.4 billion or 59%, while their foreign currency assets have increased by $2.8 billion, or almost 250%.

The banks' foreign currency business began as a natural extension of their domestic business with Canadian customers who had close commercial and financial relations with other countries. The banks thus equipped themselves with the facilities for carrying out foreign exchange transactions and the financing of exports and imports. Towards the end of the nineteenth century Canadian banks began to open offices in financial centres such as New York and London in order to provide improved service to Canadian customers and to foreign residents with Canadian interests. At the same time, banking offices were opened in areas where in addition to Canadian trade interests, there were inadequate banking facilities and opportunities to develop profitable local banking business.

Although all of a bank's foreign currency business is closely interconnected, three main areas may be distinguished. Firstly they buy and sell foreign exchange to meet the needs of their customers and provide the means for them to make payments abroad and convert foreign currency receipts into Canadian dollars. In this capacity they make markets in foreign currencies: indeed their transactions with customers, with each other and with banks abroad are the Canadian foreign exchange market. This part of the banks' operations will be described in Chapter 15.

The second class of foreign business is the local banking business which Canadian banks conduct in the Caribbean countries, in South America and on the west coast of the United States. In these areas, particularly in the Caribbean, branches of Canadian banks do a substantial ordinary banking business and in many cases are a significant part of the local banking system. Most banks manage this part of their business in basically the same way as their domestic business, with managers having responsibility for routine matters and smaller credits while larger loan applications and policy matters are passed on by regional supervisors and, finally, head offices. There has been a rapid expansion in the foreign branch systems in recent years bringing the number of branches and agencies abroad to more than 175 in 1962 compared to 102 in 1946.[16]

Important as it is, the foreign local banking business has grown much less rapidly than the third and final type of foreign currency business, which may be described as international wholesale banking. Most of the dramatic change in foreign currency deposits and investments shown in Table 7-4 has been due to strenuous competition for funds, principally in interest-bearing fixed-term form, by Canadian banks in the very active international market in U.S. dollar and other foreign currency balances. The offices of Canadian banks in financial centres abroad, particularly New York and London, play a prominent role in the competition for non-resident balances. These offices, however, are closely controlled from head offices in order that the management of the bank's entire foreign currency business

[16] It should be noted that a number of Cuban branches of Canadian banks were closed with the nationalization of foreign banks in that country a few years ago.

TABLE 7–4

THE FOREIGN BUSINESS OF CANADIAN BANKS
(millions of dollars—December 31st)

—	1954	1958	1959	1960	1961	1962	Changes from 1954 to 1962	Changes from 1959 to 1962
Foreign Currency Assets								
Gold and coins	1	2	1	1	1	1	Nil	Nil
Notes	41	53	53	44	47	46	5	— 7
Deposits with other banks	313	343	361	532	1,007	1,204	891	843
Foreign securities	322	494	526	557	673	705	383	179
Call and short loans	196	613	711	815	844	684	488	−27
Other loans	293	666	794	814	1,069	1,356	1,073	572
TOTAL	1,166	2,173	2,446	2,763	3,641	4,006	2,840	1,560
Foreign Currency Liabilities								
Deposits by other banks	83	427	530	647	703	694	611	164
Other deposits	948	1,649	1,842	2,007	2,786	3,264	2,316	1,422
TOTAL	1,031	2,076	2,372	2,645	3,489	3,958	2,927	1,586
TOTAL CANADIAN DOLLAR ASSETS	9,136	12,001	12,026	12,729	13,994	14,559	5,423	2,533

should be integrated and, in fact, the deposit liability to non-residents is frequently carried on the books of the bank in Canada. Among the main reasons for this practice have been that the agencies of chartered banks in New York do not have general deposit-taking powers[17] and that for a time there was a tax advantage to U.S. residents in carrying their balances outside the country.

The banks have undoubtedly been favoured in their competition for funds in the United States by the fact that they have not been subject to a legal maximum on their deposit rates, as are the American banks under Regulation Q of the Federal Reserve System. However, the ceilings on deposits longer than three months under Regulation Q have been raised and the competitive advantage of foreign banks is less important than it used to be except in bidding for the shortest-term funds. Much of the success enjoyed by Canadian banks simply reflects their willingness to compete aggressively for available funds. In the United Kingdom, where Canadian banks also do a sizable deposit business, there are no statutory rate restrictions applying to any of the competing banks, although the British clearing banks do enter into rate agreements on their sterling business.

In addition to their deposit business with non-residents, the banks do a substantial foreign currency business with Canadians. Some of this arises naturally out of the international commercial business of their customers, but the banks have also developed a technique by which holders of Canadian dollars may in effect acquire short-term foreign currency investments through the banking system without incurring exchange risk. The banks purchase the customer's Canadian dollars for foreign exchange, normally U.S. dollars, under an agreement to reverse the transaction at a fixed date in the future. In the interim the customer carries his foreign currency balance on deposit at the bank, earning a return formally made up of interest on the time deposit and the profit or loss on the foreign currency "swap". In effect he is earning a combined rate of return on his Canadian dollars. Whereas the banks pay common, agreed rates on their Canadian dollar notice deposits they compete very aggressively with each other, and with other channels of international investment, for these swap deposits on an interest rate basis. Although it is technically possible for a bank to do such a swap with a customer without selling the Canadian dollars and acquiring foreign currency assets for the life of the deposit, we were informed that it is the banks' practice to complete the transactions by acquiring foreign exchange in the spot market and selling it forward. Thus the funds represented by swap deposits enter the general pool of bank funds available for investment in foreign assets.

The banks are required to hold cash reserves under the general banking laws of most of the countries in which they operate. In some areas no cash requirement exists—this is true, for instance, of the offices in the United Kingdom and agencies in the United States—while in others it may run as high as 50% of deposits, as has recently been the case in the Dominican Republic. The Bank Act itself in the section on cash reserves simply states that "the bank shall also maintain adequate reserves on liabilities payable in foreign currencies". In practice, all banks do carry very liquid foreign portfolios with the result that they have had no difficulty in meeting any reasonable interpretation of this requirement. In addition to their coin and note holdings, a sizable portion of their deposits with other banks are demand balances and the remainder are principally short-term deposits.[18] Moreover, call loans to security dealers may be liquidated at any time and much of the foreign security portfolio is short-term. In fact, the outstanding characteristic of the foreign investment position is the high degree of liquidity which banks maintain as a matter of policy. While they do make a considerable volume of loans other

[17] The New York law was altered in 1960 to permit foreign banks to open branches with full deposit-taking powers.

[18] Most of the demand balances are held under reciprocal arrangements with foreign banks and are not in practice available as a source of liquidity except to meet short-term needs.

than call loans and some of these are in fact of quite long term, such loans amounted to only 34% of foreign assets at the end of 1962. It might be noted that the asset management policies of individual banks differ much more widely in their foreign than in their domestic business, some banks being much more heavily committed in loans than others. This diversity probably reflects the sheer size of the foreign markets and the possibilities of specialization in them as well as the fact that the business of Canadian banks is growing very rapidly without the more settled traditions characteristic of domestic business.

The Canadian banks have become very significant factors in two particular markets—the New York call loan market and the so-called "Euro-dollar" market. They have on occasion accounted for about one-half of call loans to New York investment dealers and brokers; their success in this market despite their inability to offer a full banking service results from their rates being a little lower than those charged by American banks. "Euro-dollars", which might more properly be called "international dollars" in view of the fact that banks in many parts of the world operate in the market, are simply U.S. dollars on deposit with banks outside the United States, including foreign branches of American banks. There is a large pool of such dollars available for international borrowing and lending because foreign banks are willing and able to borrow these funds, which are widely used in world trade and finance, at higher rates of interest than American banks until recently had been able to pay in the U.S.A. under Regulation Q. We have seen that the Canadian banks accept foreign currency deposits from foreign banks and other non-residents—in this capacity they are borrowers in the Euro-dollar market. At the same time they lend in the market to international corporations and to banks, a good share of their own deposits with banks outside the U.S.A. being Euro-dollars. The particular channels through which funds travel from the original holder of U.S. dollars by way of a series of banks to a borrower who needs the funds, say to pay for imports from the United States, are determined by patterns of bank and customer relationships throughout the world. For instance, a corporation based in Europe may borrow from a London bank, which in turn obtained funds on deposit from a Canadian bank. The main advantage to the original borrower is that he has obtained funds more cheaply than by borrowing domestically or under a line of credit established with a New York bank. Funds move more cheaply by such circuitous paths than they could directly because the lender knows the borrower at each step of the way and does not require a substantial risk premium.

The rates obtained in the New York call loan and Euro-dollar markets are key factors determining the rates which Canadian banks will pay on their own foreign currency liabilities, including the rate on "swap" deposits in Canada. It is our impression that the banks trade in these markets, borrowing here and abroad and investing in New York or elsewhere, at fine profit margins and may indeed be prepared to take losses on individual transactions in order to obtain or to keep particular accounts and develop useful correspondent relationships with foreign banks. The administrative costs of the entire operation are, however, very small so that even narrow profit margins are apparently attractive.

The net position of the banks in foreign currency assets and liabilities may fluctuate quite considerably, although it is normal for short-run changes in the "spot" position recorded on their balance sheets to be covered in the forward exchange market. When foreign assets exceed foreign liabilities the banks are using part of their Canadian dollar borrowings for investment abroad and when "net foreign assets" decline they are drawing on their foreign positions to obtain funds for investment in Canadian dollar assets. Such net sales or purchases of foreign assets enable individual banks to adjust to pressure or ease in their domestic cash and liquidity in just the same way as they adjust by sales or purchases of other liquid assets. The foreign positions have in fact been used in this way, being run down primarily in periods such as 1955-56, 1958-59 and 1962

when the banks' liquidity positions were under pressure.

In indicating the main lines of the banks' international business, we have barely suggested the breadth and complexity of the role which they now play in the world's financial markets, justifying this summary treatment on the grounds that much of this foreign currency business is not intimately connected with the workings of the Canadian financial system. We should, however, return briefly to one point. It has been argued that the "swap" deposit business, which enables Canadians to acquire foreign currency deposits which are in all essentials the same as Canadian dollar balances, and results in the banking system "creating" these close substitutes for Canadian deposits, somehow weakens domestic monetary control by building a larger banking system on a given cash reserve base. We do not believe this particular way of economizing on cash to be any more or any less a factor weakening the central bank's influence than many other ways in which the financial system generates close substitutes for money. The Bank of Canada can always take compensating action to offset the generation of swap deposits, or any other liquid asset, by acting on cash reserves and domestic interest rate levels. Although the Bank might experience serious technical difficulties if shifts into swap deposits became massive or unpredictable, we do not see any need at present to extend the cash reserve requirement by applying it to this or any other part of the banks' foreign currency business. However, if circumstances were to change markedly and in particular if the banks were to abandon the present practice of matching the "swap" deposits with foreign currency assets there might well be reason to revise this judgment in the interests of domestic monetary control. We might also note that if the banks were to invest in increasingly long-term and higher-risk assets it might be necessary to require particular liquidity ratios to be maintained on the banks' entire foreign position as a supplement to the careful review of the banks' foreign liquidity which the Inspector General now undertakes.

INSPECTION AND SUPERVISION

The chartered banks are now subject to very thorough inspection and supervision. This was not always so: indeed the present system has evolved very largely as a result of evidence that earlier inspection procedures were not adequate to protect the interests of depositors and shareholders. In the 1913 revision of the Bank Act, a shareholders' audit conducted by auditors approved by the Minister of Finance was made compulsory, and in 1923 the sections of the Act relating to the audit were strengthened. In the next year, following the absorption of one bank, the failure of another, and the revelation that their audits had previously been quite inadequate, the office of Inspector General of Banks was created by an amendment to the Bank Act. Our present system of inspection and supervision is essentially similar to that established by these amendments to the legslation forty years ago.

Within the banks the internal inspection departments, staffed by people with considerable banking experience, carry out surprise audits of all branches and of departments which have custody of valuables. It is their responsibility to audit the books of the branch, to see that all records and reports to Head Office are accurate, to satisfy themselves that proper operating procedures are being followed and to report any irregularities to management. The inspection staff pays particular attention to loans which have for any reason become doubtful. Each of the banks has established a very thorough internal inspection procedure, and this is the foundation on which other levels of the inspection system are based.

At least two shareholders' auditors, who must be from different firms, are appointed annually by the shareholders of each bank under Section 61 of the Bank Act, their appointment being subject to approval by the Minister of Finance. They must be qualified accountants belonging to a recognized professional association and having practised in Canada during the six years preceding their appointment, and must have no personal connection with the bank. After two

consecutive years, at least one of this pair of auditors must be replaced by a member of another firm. The auditors may have access to any of the books or assets of the bank. They are required to examine all loans amounting to more than 1% of the bank's capital and rest account. While they may if they choose examine all accounts, they normally rely on the reports of inspectors relating to small accounts and branch audits, having fully satisfied themselves that inspection procedures are adequate. The auditors must report to the president and general manager on the details of any large loan which appears to be bad or doubtful, and all such reports must be presented to the next directors' meeting and forwarded to the Minister of Finance. Finally, they must report annually to their employers, the shareholders, on the condition of the bank, but are not required to certify the profit and loss statement.

The third tier in the inspection system is provided by the Inspector General of Banks who has full powers to examine the banks in any way he sees fit in order to satisfy himself "that the provisions of this Act having reference to the safety of the creditors and shareholders of the bank are being duly observed and that the bank is in a sound financial condition". The Inspector General has only a small staff and relies heavily on the shareholders' auditors and through them on the banks' own inspection systems in order to carry out his duties. He receives the regular reports required under the Bank Act, and a large number of reports on individual loan accounts and security investments, and with this information as background visits each of the banks at least once a year. The Inspector General normally visits only head offices, relying on discussions with head office officials and with the shareholders' auditors for his knowledge of the soundness of the banks' whole operation. His real power, and the strength of the whole system of inspection and supervision, depends not on detailed examination by the Inspector General himself but on his power, as the responsible officer under the Minister of Finance, to pass upon the adequacy of the shareholders' audit and to enlarge the audit in any way he considers necessary. This authority, contained in sections 61(8) and (9), is the keystone of the inspection system, providing the assurance that internal inspection and shareholders' audits are always as thorough as the government may wish them to be.

In the course of his work the Inspector General, who has power to obtain any information which "he deems necessary for the performance of his duties" receives a good deal of statistical information. Some of it has been requested by him for the Bank of Canada, which has no power to request statistics, and is not directly relevant to his duties as bank inspector. We think it desirable that the position of the Inspector General should be clarified by giving the Bank of Canada power to request from institutions with which it has dealings such statistical information as it may need, subject of course to the provision that the affairs of individual customers are not to be revealed.

In addition to carrying out the duties described, the Inspector General acts as the principal advisor to the Minister of Finance on banking matters, particularly matters of a technical nature. His main duties in this capacity are to keep in touch with banking developments, to advise on each revision of the Bank Act and its regulations, and to assist in presenting new legislation to parliamentary committees.

THE BANKS' REVENUES, EXPENSES AND CAPITAL

The banks derive revenue from interest on loans, earnings on their security portfolios and from service charges of various kinds. Since the end of World War II total revenue has risen as a result of the growth of the banks, the upward trend of interest rates and the increasing share of assets represented by loans, which yield a higher return than securities. Abstracting from the growth of the banking system by relating revenue to assets, gross earnings have risen from 3.47%

TABLE 7–5

CHARTERED BANK REVENUES AND EXPENSES
as a percentage of total assets

——	1945	1951	1956	1962
Revenue				
loans	.93	1.71	2.51	3.21
securities	1.09	1.01	.82	1.11
commission, exchange etc.	.62	.75	.77	.81
capital profits	—	—	.02	.01
TOTAL	2.64	3.47	4.12	5.14
Administrative expenses				
salaries	.93	1.42	1.45	1.44
other	.46	.65	.71	.83
TOTAL	1.39	2.07	2.16	2.27
Revenue after admin. expenses	1.25	1.40	1.96	2.87
Deposit interest				
savings deposits	n.a.	.58	.82	1.00
other	n.a.	.06	.21	.87
TOTAL	.53	.64	1.03	1.87
Net Earnings before tax and provisions	.72	.76	.93	1.00
Provisions for losses and reserves	.34	.29	.26	.15
Taxes	.18	.22	.34	.44
Net published profit	.20	.25	.33	.41
Dividends	.15	.19	.25	.32
Retained for published shareholders' equity	.05	.06	.08	.09
Memorandum: Average rates earned or paid				
On loans	4.10%	4.51%	5.03%	5.90%
On securities[a]	1.87	2.30	2.47	3.80
On savings deposits	1.23	1.24	1.76	2.41
On other Canadian notice deposits	.50	.50	2.48[b]	3.95[c]

[a]Including profit or loss on trading.
[b]On balances of $100,000 or more.
[c]On balances of $25,000 or more.

of assets in 1951[19] to 5.14% in 1962, but in spite of this rapid increase the revenue is below the 5.73% achieved in 1929 and is significantly lower than that recorded by most other financial institutions. During these years the prime rate and other lending rates have risen, and the banks have also been able to improve their gross yields by investing in mortgages and in personal loans. The average return on loans in Canada is now close to 6%, which means that the banks have little further scope to increase the return on loans above the rates earned in recent years.

Income from securities needs no particular comment—it will continue to reflect the level of rates on the range of securities in which banks invest, principally short and medium-term Government of Canada issues, as well as trading losses or profits. Income from service charges and commissions has grown at roughly the same rate as bank assets for the past decade.

While revenues have been increasing quite rapidly, the banks' administrative expenses have been a good deal more stable: since 1951 they have increased only from 2.07% of assets to 2.27%. As a result, most of the increased earnings have been available to meet the cost of interest on deposits, to cover losses and taxes and for allocation to dividends, reserves and published shareholders' accounts. The lion's share of the increase has gone to deposit interest, which rose from a rate of .64% of total funds in 1951 to 1.87% in 1962. Interest on personal savings deposits has risen during the period but in recent years there has been a more rapid increase in the interest cost of other accounts, both Canadian dollar and foreign currency, reflecting the more strenuous competitive efforts discussed earlier in this chapter. Whereas savings deposits accounted for 91% of deposit interest in 1951, their share in 1962 was only 54%. It is at least arguable that the banks would have been well advised to increase the range of deposit accounts available to small savers and devote a greater share of their earnings to interest on these accounts rather than to the larger blocks of funds on which they have paid relatively high interest rates. We have noted, for example, that they have been prepared to pay high rates for foreign currency balances, abroad and in Canada, even though foreign currency assets yield significantly less than Canadian assets. As we have already suggested, we would expect

[19] Information for 1945 is included in Table 7-5 for historical purposes, but wartime developments had resulted in a most unusual structure of assets, revenues and expenses: our comparisons are therefore drawn with 1951.

the banks to devote closer attention to the range of customers holding personal savings accounts who have tended to hold an increasing share of their funds outside the banking system.

Earnings after administrative and interest expenses represented .76% of assets in 1951 and 1.00% in 1962. Provisions for losses and reserves have declined but tax provisions have roughly doubled in relation to assets, with the net result that the rate of earnings available for additions to published shareholders' equity and dividends has risen from .25% of assets to .41%. The banks have allocated an increasing share of this final spread to dividends.

In addition to increases in shareholders' equity drawn from income, amounting to $381 million in the years 1945 to 1962 inclusive, the banks have obtained $420 million of capital from the sale of new stock, raising their published capital accounts from 4.7% of assets, to which they had declined by 1945 from a peak of 11.1% reached in 1932, to a level equivalent to 5.7% of assets in 1962. Increases in dividends have more than kept pace with the growth in capital accounts so that the dividend rate in relation to published shareholders' equity had edged up from just below 5% ten years ago to 5.6% in the past few years.

It would appear from the record that there is not a great deal of slack in the banks' revenue and expense position. Increases in earnings have been allocated principally to deposit interest while administrative expenses—a measure of the efficiency with which assets are being administered—and shareholders' accounts have absorbed quite stable shares of gross revenue. Provisions for losses and reserves have declined proportionately, reflecting favourable loss experience and limitations put on the accumulation of untaxed reserves.

We have already suggested some ways in which the banks might have made more productive use of their earnings, as by devoting more of their interest payments to variants of personal savings deposits and spending somewhat less than they have on branch expansion. Such different responses to the competitive situation in

ALLOCATION OF GROSS REVENUE
(percent)

	1945	1951	1956	1962
Salaries, etc.	35.1	41.0	35.2	28.0
Other administrative expenses	17.4	18.6	17.2	16.1
Deposit interest	20.3	18.5	25.0	36.3
Taxes	7.0	6.2	8.1	8.7
Provisions for:				
losses and reserves, net	12.9	8.5	6.4	2.9
shareholders	7.3	7.2	8.1	8.1
TOTAL	100.0	100.0	100.0	100.0

which the banks have found themselves might well have improved their position significantly. The over-riding fact, however, is that the banks are now in a position such that increases in the general level of interest rates above the level of recent years would make it extremely difficult for them to compete successfully for funds. Expenses could no doubt be pared in many ways and deposit interest might be differently distributed, but the revenue rate cannot be increased a great deal within the present interest rate limitations. This is potentially a serious situation, not because equity among institutions is an important end in itself, but because rigidities such as the 6% ceiling artificially prevent banks from providing the best possible service to the economy by limiting their ability to borrow and to lend to the customers who rely on them for funds. The banks' shareholders have not suffered and can always dispose of their stock if they wish—our concern is the broader inequity which affects the banks' customers and lowers the efficiency of the whole financial system.

Two particular features of the legislation concerning chartered bank capital merit attention at this point, the first relating to the value and issuing of bank stock and the second to their reserves against contingencies and bad and doubtful debts.

The Bank Act specifies that bank stock have a par value of $10 and further prohibits banks from issuing stock at a price greater than its current book value, measured by the combined rest account and paid-up capital. The banks have

argued before us that the par value, which was reduced from $100 to $10 in the 1944 Bank Act Revision in order to promote the wide ownership of bank stock, needs further consideration in view of the fact that the market value of bank stocks is now well in excess of the $10 par. The par value and the limitation on sale price were related to the old provision that shareholders were liable in the event of serious loss or insolvency for double the amount of their capital subscription, their purpose being to prevent shareholders from diminishing their liability by issuing new stock at more than book value. In the years following the 1934 revision of the Bank Act the double liability provision was reduced and finally removed in step with the gradual removal of the banks' right of note issue. With it the need for regulation of the price of bank stock disappeared.

While some investors feel that a specified par value confers status on bank shares, it has no practical effect and we believe that banks should be free to convert their stock into no par value shares if they so wish. We also consider that they should be free to split their stock if they believe this will contribute to wider ownership, either by reducing the par value of their shares or after converting them into no par value shares. We do, however, recommend retention of the provision that all new bank stock must be issued pro rata to existing shareholders since this helps to assure the owners of equitable treatment and no case was made for its removal. This in effect precludes banks from issuing stock options to management; no evidence was placed before us that banks need this power to attract and retain qualified senior officials, and we are not prepared to make a recommendation for change.

Freedom to issue new stock at above book value, if exercised by the banks, would mean issuing rather fewer shares at rather higher prices than has hitherto been the case. Assuming, as is reasonable, that total dividend payments are related to total earnings and not to the number of shares outstanding, the shareholders' income will thus be unchanged for any given amount invested in bank stock. Any capital gains, however, would tend to be rather less in the form of "rights" and rather more in the form of the appreciation of share prices resulting from the fact that fewer shares would be outstanding and less "dilution" of the capital would occur. We therefore recommend that the relevant sections of the Bank Act be amended to free the banks of the present issue price restrictions.

A special feature of bank legislation not unrelated to bank capital is that these institutions may hold general contingency reserves in addition to specific reserves for losses expected on particular accounts and to write down corporate and municipal securities to market values. Neither of these two types of provisions need be publicly disclosed and banks may build up such untaxed inner reserves subject to a limit set by the Minister of Finance. Since 1944 the Minister has been required by the Bank and Income Tax Acts to notify the Minister of National Revenue of any excess of reserves over "the reasonable requirements of the bank", but the Acts do not indicate how he is to determine what is reasonable and what excessive, this being left to regulations issued by him. Various changes in recent years have reduced the permitted percentage of tax-free reserves to total assets. Federal and provincial securities are now valued on an amortized basis, and reserves may not be held against them; the maximum allowable ratio now includes specific reserves which were formerly allowed as an additional item; and the allowable ratio itself has been reduced by use of an arithmetic formula related to changes in the banks' loss experience. Under this formula, the limit on tax-free reserves has come down from about 5% of the related assets in 1959 to 3.504% in 1963. Since the Inspector General told us that the specific reserves amounted to .673% of such assets in 1962, this indicates that the general reserves allowable would amount to 2.831% in 1963 if the specifics remained unchanged. The Inspector General also informed us that at the end of the 1962 fiscal year the banks were permitted to hold contingency reserves of $326

million in addition to specific reserves, compared to a maximum of $320 million in 1953.[20] These figures do not include unpublished reserves which banks, like other corporations, may accumulate out of tax-paid income. No untaxed reserves may be transferred to shareholders' equity without full payment of taxes and a large part of such accumulations of tax-paid reserves arise in preparation for such transfers to published shareholders' equity. We will return to the broader issues raised by the existence of unpublished tax-free reserves in Chapter 19.

THE BANKS' POSITION IN THE FINANCIAL SYSTEM

We have seen that the chartered banks hold a strategic position in the financial system as a result of their size and of the fact that they serve so wide a range of deposit and borrowing customers, including other financial institutions. Over the years very close working relationships have developed with these institutions, most of which hold their cash reserves in chartered bank deposit accounts. Table 6-1 shows that $1.5 billion of the total of $17.7 billion of currency and deposits outstanding at the end of 1961 were held by other financial institutions and the bulk of these were deposits in chartered banks. Financial institutions do hold relatively small amounts of deposits elsewhere, but bank deposits are the preferred form of cash because of the convenience of the banks' large branch systems, the fact that the banks operate the clearing system, and the value to a financial institution just as to any other business of a "good bank connection", in which the crucial element is a line of credit under which the institution may borrow as need arises.

The banks are authorized by the Canadian Bankers' Association Act to operate clearing houses, of which the Quebec Savings Banks are also members: the Bank of Canada is a member but has no voice in clearing house management. The clearings and payments system consists firstly of the arrangements by which cheques and other orders are routed between branches and the customers' deposit accounts are debited and credited, and secondly of arrangements for settlement of balances between the financial institutions. When a bank branch receives a cheque on another bank for credit to the account of one of its depositors, it routes the cheque as rapidly as possible to the bank on which the cheque is drawn in order to receive the funds. Local cheques are cleared locally and there are in principle as many "clearing houses" as there are arrangements for the local exchange of cheques. If only a few banks are represented at a particular place, the "clearing house" simply consists of their local branches. In larger centres the clearing house will include all banks, and the local main branch of each bank acts for its other branches in the area. To the extent that these local clearings result in balances owing between banks, "settlement vouchers" are issued. These are forwarded by the bank to whom payment is due, along with all "out-of-town" cheques, to its main branch at the nearest point where the Bank of Canada has an Agency. The balances due between banks in the clearings at these points, arising from their own local clearings, from the settlement vouchers coming out of local clearings elsewhere, and from the exchange of all "out-of-town" items, are settled by transfers in the banks' deposit accounts at the Bank of Canada. It is at this point that some banks lose cash reserves and others gain them.

Institutions other than banks which accept chequable deposits must arrange for cheques drawn by their customers to be accepted wherever they may be presented for payment and to be routed back to them. They do so by carrying clearing balances with one or more banks, the banks accepting their cheques and routing them back in the normal manner to the branch where clearing accounts are held. Thus when a cheque on a trust company with offices only in Ontario is received by a bank in, say, Nova Scotia, it is presented at the clearings to the bank which acts

[20] Submission of the Inspector General of Banks, para. 43. Proceedings of the Banking and Commerce Committee, Decennial Revision of the Bank Act, 1954, Exhibit 31, page 775.

as local agent for the trust company. Settlement is made between banks in the usual way and the cheque is forwarded to the branch where the clearing account is kept, debited to the account and presented to the trust company. The banks have developed a very efficient organization to handle this essential job of managing the payments and clearing system, and are constantly working to improve it.

The banks have a great many close working relationships with other financial institutions in addition to those associated with the clearing system. Investment dealers, finance companies, and many small financial institutions borrow a substantial part of their funds from banks at all times. Other financial intermediaries which do not regularly borrow from banks nevertheless rely on their lines of credit as a source of funds when need arises. Competition between the banks for the accounts of these institutions has ensured that they have not been discriminated against when credit has been scarce, with the special exception—already referred to—of the larger sales finance companies. The chartered banks thus contribute very significantly to the liquidity of the entire financial system because of their role as the main purveyor of short-term credit and chequable deposits to the economy as a whole. In addition to acting as banker to other financial institutions, the banks provide them with a full range of related services, and participate with them in a variety of lending and underwriting ventures. These general relationships which tie the banks inextricably into all parts of the financial system are supplemented in many cases by ownership, directorate, and operating links between individual banks and other financial institutions. These will be described in conjunction with the operations of such institutions, although their implications in terms of the competitiveness and concentration of the financial system will not be analysed until Chapter 18.

As our biggest short-term lenders and borrowers and as principal administrators of the payments mechanism the banks have a powerful position in the financial system, a position which is reinforced by their tendency to undertake directly or indirectly a wide range of related financial activities. While the fundamental character of their business remains the same as it was three decades ago, they have been willing to make significant changes in the pattern and character of both their lending and deposit-taking activities in response to changing needs and conditions. Despite the fact that they have served the country well on the whole, their relative position has declined. This has resulted from the changed nature of the economy's credit requirements, from the limitations on the banks' activities which we have discussed, and from the fact that the banks' own competitive efforts have not always been sufficiently strenuous and well-directed. Thus, although they have begun to put more emphasis on longer-term lending and borrowing in response to the economy's relatively increased requirements in this area, this process might well be carried further and almost certainly would be if the mortgage prohibition and loan rate ceiling were removed. At the same time, one should not leave the impression that the traditional short-term banking business and the virtues of careful lending are out of date. In any event, one might hope to see a greatly increased variety of special bank lending and deposit arrangements, more differences in the business done by different banks—which they have shown to be possible and profitable in their foreign business—and more reliance on price competition and relatively less on prestige and service factors, even though the nature of the market will always preclude there being a large number of national banks. While the banks will never be in a position to fill all the financial needs of the country and other institutions will have a vital role to play, the chartered banks will continue to be a major force in our financial system. We will, therefore, make recommendations designed to permit and encourage them to play a more flexible and useful role.

CHAPTER 8

THE QUEBEC SAVINGS BANKS

In contrast to the chartered banks, which have become large national institutions engaging in a broad range of financial activity, the two Quebec Savings Banks have retained many of the local characteristics of their origins. They are much smaller, operate only in Montreal and Quebec and have specialized in one particular type of business. Their traditional emphasis on personal savings business can be traced back to the formative years of banking in Canada, when the chartered banks tended to concentrate on business deposits and lending and were less interested than they now are in attracting small savings. Together with the fact that bank failures were not uncommon, this lack of emphasis on the savings side of banking led to the establishment of institutions to provide people with a thoroughly safe haven for their funds. Legislation "to encourage the establishment of and regulate Savings Banks" was passed in 1841 and banks were founded by the colonial government and by private interests such as the group led by the Bishop of Montreal which in 1848 took over the Montreal Bank established two years earlier, and a similar group which founded the bank in Quebec City at the same time. These two institutions were mutuals until brought under dominion legislation in 1871: since then they have operated as joint stock companies under a separate Savings Bank Act. There was at one time a savings bank in Ontario, but since 1890 the Act has applied only to the two Quebec institutions and has in fact contained no legal machinery for setting up new savings banks. Other institutions, notably the chartered banks, trust and loan companies and credit unions have filled the place originally intended for a system of federally chartered savings banks.

The most important distinguishing feature of this Act, which has been considerably revised during the past fifteen years, has been the strict limit imposed on the savings banks' investment powers with a view to precluding them from commercial banking and ensuring the safety of their deposits. This legislation originally directed the savings banks' funds largely into government securities: it appears that the Minister of Finance at the time the Act was drawn up was interested in assuring a market for government debt as well as in protecting savings bank depositors. They may still invest without limit under Section 58 in securities issued by governments, school boards, religious bodies including Quebec parishes, hospitals and in railway equipment certificates. However, Section 59 specifies that they may devote only 15% of their deposits to combined holdings of the securities and preferred shares of corporations, subject to certain qualifications,[1] and chartered bank stock with a five-year dividend record or any other security approved by Treasury Board.

Prior to 1948 they were not permitted to buy other securities, invest in mortgages, or grant unsecured loans except to governments, school

[1] These qualifications require that the company's common shares (or those of its parent company owning more than 50% of the stock) be listed on a recognized stock exchange, that the company has paid out of current income a dividend on all its stock or interest on its securities in the five preceding years and that it have paid-up capital and surplus in excess of $500,000.

boards and religious bodies; direct lending other than to the federal or provincial governments was limited to 5% of deposits. They were empowered to grant secured loans to any person on the collateral of any securities provided that specified margin requirements were met. In 1948, they were first allowed to take mortgages, and subsequent revisions have extended their power until they may now invest 60% of their deposits in N.H.A. mortgages and in other residential mortgages up to the lesser of $100,000 or 60% of the value on each investment. Mortgage loans were specifically exempted from the 6% ceiling applying to other loans and advances. The 60% loan to value ratio was intentionally set at the same level as that applying to other institutions so limited, but has remained at 60% while since being raised for others.

The same revision of the Act first permitted the Savings Banks to make unsecured loans, including personal loans, but even after subsequent broadening of their powers they are still limited to placing 5% of deposits in unsecured loans and any unsecured personal loan may not exceed $5,000. (It is odd that this 5% limit applies to direct lending to public bodies such as municipalities and school corporations while the savings banks may purchase without any limit or accept as 100% collateral the unsecured issues of these same public bodies. There is a similar anomaly in that the savings banks are not limited in the amount of secured loans they may grant although the 15% limit applies to direct investment in some securities which may be taken as collateral.) Finally, an amendment in 1957 allowed them under Section 59A of the Act to invest one-half of their paid-up capital and rest account in corporate securities which do not otherwise qualify for purchase, provided they are not in default. These revisions, particularly the opening of mortgage investment, have broadened savings bank investment powers considerably but it remains true that the legislation is restrictive, seeking to protect the security of funds by limiting the uses to which they may be put.

Under Section 55 of the Act the savings banks must hold a cash reserve equal to 5% of deposits in Bank of Canada notes or deposits or chartered bank deposits and a further 15% of deposits or additional cash in federal or provincial securities. Whereas the chartered bank cash requirement of 8% now refers to average levels in each month, the savings banks must hold these reserves at all times as did the chartered banks before 1954. It was argued in 1954 that since the savings banks had so few commercial accounts their deposits were less volatile than those of chartered banks and they did not need the convenience of a monthly averaging system. The savings banks have not so far found that the basic liquidity rules of Section 55 impose additional burdens on them both because they earn interest on part of their cash held at chartered banks and because in any event the restrictions on other types of investment have led them to employ well over 15% of their funds in federal and provincial securities.

RECENT TRENDS IN THE BUSINESS

In 1945, prior to the first significant changes in their investment powers, 87% of the savings banks' funds were invested in securities, principally those of the federal and provincial governments. Since 1948, they have invested a high portion of the new funds coming from the growth of their deposits in mortgages and loans. At the end of 1962, these two made up about 35% of their assets and the proportion has continued to rise rapidly. Table 8-1 also shows that their holdings of securities have changed very little in total during those years, although there has been a substantial shift from federal and into other securities. The savings banks have taken full advantage of the freedom to invest in higher-yielding assets and, in spite of the progressive broadening of the Act during the 1950's, have approached some of the limits set by legislation. At the end of 1962, their unsecured loans, including personal instalment loans similar to those offered by the chartered banks, were up to 4% of deposits compared to the statutory limit of 5%, and mortgage investment at 27% of deposits was rapidly approaching the 40% maximum set by the 1957 amendment: in late 1963 the limit

TABLE 8–1

ASSETS AND LIABILITIES OF THE QUEBEC SAVINGS BANKS
(December 31)

	1945		1950		1955		1962	
	$ mn.	%	$ mn.	%	$ mn.	%	$ mn.	%
Assets								
Cash[a]	8.7	6.1	13.0	6.4	18.5	7.0	29.3	8.2
Securities								
Govt. of Canada	97.2	67.9	93.0	45.7	54.9	20.7	32.2	9.0
Provincial			51.5	25.3	80.0	30.2	82.9	23.2
Municipal	20.8	14.5	25.2	12.4	56.7	21.4	39.2	11.0
Other	6.8	4.8	9.5	4.7	16.2	6.1	25.5	7.1
SUB TOTAL	124.7	87.1	179.1	88.0	207.8	78.4	179.9	50.4
Mortgages	—	—	0.5	0.2	19.7	7.4	97.5	27.3
Loans	5.0	3.5	4.4	2.2	8.2	3.1	27.0	7.6
SUB TOTAL	5.0	3.5	4.9	2.4	27.9	10.5	124.5	34.9
Other Assets[b]	4.6	3.2	6.6	3.2	10.9	4.1	23.6	6.6
TOTAL	143.1	100.0	203.7	100.0	265.1	100.0	357.2	100.0
Liabilities								
Public deposits	129.5	90.5	190.3	93.4	246.8	93.1	323.8	90.6
Deposits of govts[c]	0.8	0.6	0.4	0.2	0.5	0.2	13.1	3.7
Secured bank loans	1.6	1.1	2.3	1.1	5.3	2.0	3.6	1.0
Other liabilities	1.5	1.0	0.5	0.2	0.6	0.2	1.6	0.4
Shareholders' equity	9.7	6.8	10.2	5.0	11.9	4.5	15.1	4.2
TOTAL	143.1	100.0	203.7	100.0	265.1	100.0	357.2	100.0

[a]Includes Bank of Canada notes and deposits at the Bank of Canada and chartered banks.
[b]The main items included are other cash items, bank premises and Poor Fund investments.
[c]Government of Canada and provincial governments.

was raised to 60%. Most of the mortgages are conventional rather than N.H.A. since the two banks find the term of the latter too long, the margins too slim, and the lending and repossession procedures troublesome.[2]

While the savings banks have been anxious to take advantage of the opportunity to offer mortgage and loan facilities as well as the traditional deposit service to their non-business customers, they have not attempted to attract commercial business (other than some mortgage lending on small apartment buildings) even to the very limited extent permitted by the Act. Nor have they made much use of the freedom obtained in 1957 to invest one-half of their capital and rest funds in any corporate securities not in default. Indeed, in their submission and in evidence before us the savings banks stressed that their policy was "to ensure the highest degree of security for the money entrusted to them and to provide complete financial services for the individual and the family"[3] and emphasized that they are not at present interested in making loans to industry and commerce.[4]

While there have been these quite substantial changes in the structure of savings bank assets in recent years, their liabilities are pretty well unchanged. Nearly all of their deposit accounts are similar to chartered bank personal savings de-

[2] Transcript, page 1928.

[3] Transcript, page 1867.

[4] Transcript, page 1865.

posits: they are transferable by cheque, although nominally subject to notice, and are held by individuals as working accounts and as a savings instrument. They tend to be used somewhat more as a means of payment and somewhat less as a pure savings instrument than are the comparable accounts in chartered banks and their average rate of turnover is slightly higher. The savings banks also offer a personal chequing account which has proved no more successful than the similar accounts offered by the chartered banks. In addition they hold relatively small federal and provincial government accounts: the former are used principally in connection with the sale and redemption of Canada Savings Bonds and in recent years the balances have been nominal except during the annual sales campaign.

The savings banks have not attempted to attract business by offering a variety of accounts to the public and are apparently unwilling to complicate their deposit structure.[5] Nor have they made much use of interest rates as a competitive weapon, preferring to rely for the most part on the single savings account, to pay the same rate as the chartered banks on it and to levy the same charges for managing deposit accounts as well as for other services. We were also told that they are not interested in competing for larger blocks of interest sensitive funds as other institutions have done with considerable success, although they participate to some extent in the day and call loan markets. Indeed, they do not appear to have experimented very much to meet the competition of the chartered banks and caisses populaires. The latter, which have essentially similar objectives and serve the same market, have grown much more rapidly than the savings banks. The Quebec bank keeps the same business hours as the chartered banks but the offices of the Montreal bank have for many years been open from seven to eight in the evening in addition to the regular banking hours.

The Quebec Savings Bank Act restricts each of the banks to opening branches within a particular geographical area, the limits being defined since 1954 to coincide with the territory of the Montreal and Quebec Appeal courts respectively. These geographical limits, which date from the founding of the banks by groups with local interests in Montreal and Quebec, have not stood in the way of the branch expansion which each bank has wished to undertake, for each one has in any case stayed within the urban area where it was first established, the Montreal bank now having 61 branches and the Quebec bank 19. Nonetheless, we fail to see any advantage in setting territorial limits to the activities of financial institutions, or in giving them exclusive rights in a given area.

In view of the fact that they have offered the same deposit rate as chartered banks without being able or willing to compete fully with them in other banking activities, it is not surprising that the savings banks' share of personal savings has grown rather slowly, as can be seen in Table 7-2 in the previous chapter. Their deposits expanded more slowly than chartered bank personal savings deposits until recently when considerable branch expansion and the development of mortgage and, to a lesser extent, personal loan business have borne fruit in a more rapid growth rate.

Savings bank deposit business has been responsive to changes in credit conditions, the changes in the growth rate matching those in the chartered banks' personal savings deposits quite closely in both amplitude and timing.[6] Thus, the increase in their deposits came to an end late in 1955 at about the same time as the increase in chartered bank deposits was restricted by the Bank of Canada. Again in late 1958, the savings banks were affected promptly by the move to a restrictive monetary policy. The close similarity between much of the deposit business of the two groups of banks results in very similar behaviour through the cycles of monetary policy. On the other hand, cycles in the structure of assets have been much less pronounced than for the chartered banks,

[5] Transcript, page 1911.

[6] Chart 3 in Chapter 11 compares the cyclical behavior of savings bank deposits and competing institutional liabilities.

largely because the savings banks do not lend to businesses, whose credit demands vary so widely.

In periods when the growth of deposits falls off, the savings banks have liquidated securities on the modest scale necessary to continue increasing their mortgage and loan investment, although at a somewhat reduced rate. While most of the liquidation has been by running off maturing issues rather than by market sales, the savings banks have made some outright sales and have traded their security portfolios to a limited extent. One of them lengthened its portfolio quite substantially in a period of high interest rates and now has substantial holdings of long-term bonds.[7] In a period such as 1959-60, when the availability of funds to them is affected strongly by tightening credit conditions, their reluctance to sell bonds leads them to cut back a little on their mortgage and loan programs, and in these circumstances they reject applications for speculative loans—particularly on apartments—scrutinize the reasons for all loan applications carefully and "make it a rule to satisfy as many borrowers as they can in preference to making only a few large loans".[8] Their lending rates, which since permission to grant unsecured loans was received in 1948 have been subject to the same 6% maximum as the chartered banks, move in step with changes in bank rates. Mortgage rates, which are not subject to the ceiling, fluctuate with the rates charged by other mortgage lenders: effective rates on personal loans, which with service and insurance charges included are in the range of 7½%-9%, apparently change little if at all.

Thus, in spite of the fact that the savings banks are not required to hold all of their cash reserves at the central bank, they are responsive to changes in central bank policy through the influence of changes in the general level of interest rates and in the demand for credit on their competitive position. The effect of these general forces is magnified because they do not compete at all vigorously on an interest rate basis: the inflexibility of their deposit rates thus results in a pronounced cyclical variation in the flow of funds to them. Their cash reserve positions reflect changing pressures in the markets, there being some tendency to run the cash ratio down and to increase the amount of borrowing from chartered banks in periods of tightness. However, these cash adjustments have not been large and have not significantly affected their response to central bank policy.

The shift into higher-yielding assets, particularly mortgages, has led to a substantial improvement in the revenues and earnings of the savings banks. Gross revenue increased from 3.25% of assets in 1951 to 5.10% in 1962, while earnings after administrative and interest expenses rose from .44% to .88% of assets in spite of a substantial increase in administrative costs associated with rapid branch expansion and the development of new business. Their gross earnings ratios are now close to the chartered banks' but administrative expenses are lower because of the more limited services offered. However, their interest costs are higher as a result of the absence of current accounts. These differences just about offset each other, and net revenue at .88% of assets in 1962 was close to the 1.00% of the chartered banks. The savings banks' ability to compete for business has improved markedly since they began taking on mortgage and loan business after 1948. In 1962 they earned 9.4% net after taxes on shareholders' equity compared to 6.3% in 1950. In the same interval, equity has increased 40%, entirely out of retained earnings.

The savings banks may carry tax-free inner reserves under a formula similar to that which used to apply to chartered banks. This permits them to accumulate such reserves up to 5% of reservable assets, defined in the same way as for chartered banks, but if they exceed the limit they need transfer only one-fifteenth of the excess to taxable earnings in each year rather than the entire excess as the chartered banks now must do. They also carry tax-paid reserves and, like the banks, need not disclose the amount of the combined inner reserves or transfers to them.

[7] Submission of the Quebec Savings Banks, Schedules V and V.A.

[8] Submission of the Quebec Savings Banks, para. 166.

TABLE 8–2

SAVINGS BANK REVENUES AND EXPENSES AS A PERCENTAGE OF TOTAL ASSETS

	1951	1956	1962
Gross Revenue	3.25	3.93	5.10
Less: Administrative expenses	1.39	1.49	1.89
Revenue after administrative expenses	1.86	2.44	3.20
Less: Interest paid on deposits	1.42	1.76	2.33
Net earnings before tax and provisions	.44	.68	.88
Provisions for losses and reserves	—	.18	.09
Taxes	.13	.19	.40
Net Profit	.32	.31	.39
Dividends	.19	.17	.23
Retained for shareholders' equity	.13	.14	.16

THE LEGISLATION: OUR VIEWS AND RECOMMENDATIONS

In the course of recent revisions, many parts of the Quebec Savings Bank Act have been brought into line with comparable sections of the Bank Act. The most important distinguishing features of the legislation governing savings banks relate to their investment powers. These restrict the types and amounts of assets in which they may invest and effectively prohibit unsecured lending to business, while giving them the power, not granted the chartered banks, to make conventional residential mortgage loans and charge more than 6% on them. Other differences in the two Acts are of much lesser importance and could be removed by a continuation of the process of revision already set in train without significantly altering the present legislative difference between chartered and savings banks.

A number of changes suggested by the savings banks, for instance that the legal par value and limitations on the issue price of their stock be removed and that the directors' share ownership requirements be lowered, are in line with the recommendations we have already put forward in commenting on the same parts of the Bank Act and are equally desirable for the savings banks.[9] It would also be appropriate that savings bank directors be subject to the age limit of 75 which has applied to chartered bank directors since 1954, granting them the same five year interval as was given the chartered banks to meet this requirement. Finally, among these important but not fundamental improvements, Schedule A of the Act, which sets out the form for monthly balance sheet reports, might be amended in order to bring out the cash and liquid position of the savings banks more clearly, in particular by clarifying the asset item "other cash and deposits" and showing treasury bills and money market loans separately.

In addition to these changes, the savings banks recommended further liberalization of their lending powers, suggesting that public utility bonds be included among the securities they may buy without limit, that the 15% maximum on "restricted" securities be raised to 20% and that the ceilings on mortgage investment and unsecured lending be substantially raised. If this approach to the legislation is to be taken, broadening it while still subjecting the savings banks to restrictions, we would prefer to go somewhat further than the banks themselves have requested and to simplify the Act by removing unnecessary distinctions which do not reflect any fundamental or unique features of the business in which they engage. Thus if a separate Savings Bank Act is to be continued, we would recommend that the restrictions in sections 59 and 59A of the Act now applying to investment in corporate securities be removed rather than raised and that the savings banks have unlimited freedom to invest in these as in the government and institutional securities now listed in Section 58.

We further recommend that there be no limit on residential or non-residential mortgage investment in the Act. In their submission presented

[9] In 1963 the par value of savings bank stock was lowered from $10 to $1 and the directors' qualifying investment was set at 500 of the new shares.

to us in 1962, the savings banks requested that a limit of 60% of deposits apply to conventional residential mortgages but admitted that they picked that number simply because they thought it more likely to be accepted than a request for complete freedom.[10] This request has since been met, but we see no purpose in imposing a limit as high as this, particularly when other institutions have not been subject to this sort of restriction, and indeed have operated successfully with even higher mortgage holdings. The restriction on unsecured lending seems just as anomalous to us and at the very least should be raised to 15% of deposits with a $10,000 limit on personal loans. As a final step in this first approach of amending the legislation but retaining a separate Savings Bank Act, it might well prove desirable to reconsider any remaining investment limits as soon as they become an unnecessary constraint.

If logic and the changing needs of the community suggest that the savings banks should be free to evolve even further, it is reasonable to consider whether the remnants of the Act's original restrictive clauses serve any useful purpose. While its first authors would now have difficulty in recognizing the Act because of the continuous process of broadening which it has undergone, it is still based on the premise that investment restrictions are the main safeguard of the depositors when in fact this now depends almost entirely on the skill and maturity of management and on the thorough government inspection and supervision for which the Inspector General of Banks has been responsible since 1934. Recognition of the real source of the depositors' protection has produced many compromises with the traditional beliefs embodied in the Act, with the result that savings banks may now invest 80% of their funds in such "risky" assets as mortgages, unsecured loans and corporate securities, that is to say all but the 20% of deposits which must be held in cash and secondary reserves. It is difficult to see how such investment limits can in themselves serve to protect the depositors from loss. Moreover, it hardly seems sensible to preclude the savings banks from commercial lending while directing the chartered banks into it, meanwhile doing the reverse with mortgage lending, and then to justify both opposing constraints on the ground that they each contribute to the protection of depositors.

The fact is that unwise management can lead to trouble whether the institution invests in loans, mortgages or other assets and that wise investment judgment backed by adequate supervision such as now exists for chartered and savings banks is the strongest protection provided. We would therefore prefer to eliminate what we see as unnecessary restrictions in the law—the removal of which would no doubt be considered in any event as soon as further development brings the savings banks up against them—and bring the savings banks under the legislation applying to other banking institutions. This would remove the territorial limit on their activities, would subject their deposits to whatever cash and other reserve requirements were applied to comparable chartered bank liabilities, and would free them from detailed restrictions on their loans and investments. Assuming that they were free to continue making conventional mortgages—which we believe they should be even if the Bank Act were unchanged—the maximum loan to value ratio should be the same as for other regulated institutions.

The savings banks, although free to specialize as they wished, would no doubt continue to concentrate their attention on personal and family business for some time to come, if only because other lending skills would not be acquired overnight. They would be able, however, to serve these customers more adequately by expanding their loan and mortgage services and, perhaps, by catering to the credit needs of small businesses. The mere fact that they came under broader legislation would not oblige them to develop in any particular way, but would allow them to evolve in whatever direction they saw profitable opportunities of serving the community's needs, subject to the general requirements of the Act. A savings bank might, indeed,

[10] Transcript, page 1915.

choose to continue exactly as it would have under the present Act and could do so without encountering any new problems or competitive pressures stemming from this legislative change. These two old and well-established financial institutions, while carefully managed, have admittedly been relatively slow to change traditional attitudes, particularly on the liabilities side of their business, and sometimes have been far from vigorous in the competitive struggle for funds. This has been no doubt partly because of the philosophy of the Act which governs them, but in recent years they have shown that their approach to business can be very modern and that they are by no means unwilling to use many of the new lending powers open to them. We see no point in inhibiting this development by retaining restrictions which are now out of date, which may well become even more inappropriate in future, and which act to discourage the formation of new savings banks within the existing framework of legislation. In our view, savings banks should have the greatest possible flexibility to adapt to the changing character of the community they serve, and we hardly consider it dangerous to recommend giving them the same degree of freedom to meet this challenge as that under which, subject to intelligent inspection and supervision, their main competitors have operated so soundly.

CHAPTER 9

THE CAISSES POPULAIRES AND CREDIT UNIONS

While all but one of the ten chartered and savings banks have played an important role in the Canadian economy since before the turn of the century, virtually all of the 4,700 caisses populaires and credit unions in Canada were founded during the past generation. The movement now has close to three million members in its local societies, holds assets of more than $1.6 billion and has emerged as a significant part of the financial system. This growth has been due in large measure to the co-operative basis, local roots, and diversified character of individual credit unions and caisses populaires—a striking contrast to the factors underlying the development of many other institutions. The number of local societies shows signs of levelling off but we have no doubt that the movement will continue to expand rapidly in dollar terms and will further broaden the range of services offered to its members.

The first caisse populaire was established in Lévis, Quebec in 1900 by Alphonse Desjardins who took as his model the co-operative "Peoples' Banks" which had grown up in Europe. This co-operative society was to promote thrift by collecting the savings of its members and, when members had good reason to borrow, to lend to them at lower rates than they could obtain elsewhere. Controlled by its members through elected officials, it stressed the "self-help" which a community of people of limited means could give each other by joining together to make sound and productive use of their own savings. The movement spread slowly among the French-Canadian population and then across the border to the United States where its orientation was distinctly altered. Whereas the caisses stressed the virtues of thrift, and lent to members only for productive purposes or to meet emergencies, the American "credit" unions were less inclined to view borrowing as a necessary evil, emphasized their ability to lend to members at low rates, and introduced the principle that membership should be limited to people having a "common bond" of association based on employment, social or other factors. This philosophy has led to the formation of many small societies devoting their resources largely to consumer lending to their members, but because of its limited objectives and the competition of other savings institutions—some of them mutual—credit unionism in the United States has not achieved the position it now holds in Canada.

In this country, the second major impetus came in the 1930's from a group working at St. Francis Xavier University in Antigonish, Nova Scotia, which promoted credit unions as part of a broad program of co-operative economic organization. They retained the American "common bond" philosophy, but with their general interest in adapting co-operative principles to business as well as consumer needs they interpreted it more broadly to cover communities as well. Credit unions of the Antigonish type sprang up rapidly in the Maritime provinces during the 1930's, most of them in farming and fishing communities

where they accepted funds from and lent to small local business members and other co-operatives as well as individuals. The movement also took root in Western Canada before the Second World War. While these two forms of financial co-operative, the caisses populaires and Antigonish credit unions, were expanding in different parts of the country, the third variant returned from the United States and developed rapidly in English-speaking Canada, particularly in Ontario.

It will be seen from table 9-2 that at the end of 1960—the most recent date for which we have complete information—about 70% of the credit unions in the Atlantic Provinces and more than one-half of those in the Western provinces were organized along the community lines favoured by the Antigonish tradition while in Ontario most locals were of the common bond type favoured by the American-inspired strand of the movement. While there are exceptions, the community credit unions dealing with a cross-section of individuals, and sometimes small businesses, tend to be larger than those which follow the American consumer-oriented lending tradition. Those in towns and cities are bigger than the rural societies; for example, only 35% of the caisses populaires are in urban communities but they had 73% of total assets at the end of 1960. As shown in Table 9-3, the caisses populaires tend to be larger than credit unions, 15% of them having assets in excess of $1 million compared to 3% of credit unions. There are also relatively fewer small caisses populaires, while the majority of credit unions organized on the strict interpretation of the common bond are small, having between $25,000 and $150,000 of assets. Those organized on community lines in rural areas tend to run between $100,000 and $300,000, also well below the average size of caisses populaires which was $563,000 in 1960. Averages can of course be misleading, and in some provinces such as Saskatchewan where many community credit unions have been estab-

TABLE 9–1

THE GROWTH OF CAISSES POPULAIRES AND CREDIT UNIONS

	CAISSES POPULAIRES			CREDIT UNIONS[a]			TOTAL	
	thousands of members	number of locals	assets $ millions	thousands of members	number of locals	assets $ millions	assets $ millions	ratio to chartered bank personal savings deposits %
1930	45	150	11.2	n.a.	n.a.	1.2	12.4	n.a.
1940	119	549	21.2	77	605	3.7	24.9	1.7
1945	389	912	124.5	210	1,302	20.9	145.4	5.5
1950	619	1,088	234.5	418	1,789	74.5	309.0	7.4
1955	883	1,146	425.8	844	2,947	218.2	645.0	11.5
1960	1,268	1,243	738.8	1,288	3,418	541.9	1,280.7	17.8
1961	1,355	1,261	834.8	1,396	3,436	656.6	1,496.4	19.6

[a]Including caisses populaires outside Quebec. Here and elsewhere in the chapter, references to the caisses populaires relate only to the societies affiliated to the two federations in the Province of Quebec.

SOURCE: Submissions of caisses populaires and credit union associations.

TABLE 9–2

DISTRIBUTION OF LOCALS BY TYPE[a]
(END 1960)

—	CREDIT UNIONS						CAISSES POPULAIRES	
	New Brunswick and Nova Scotia		Ontario and Quebec		Prairie Provinces and British Columbia			
	number	%	number	%	number	%	number	%
Urban community	54	14	42	3	142	13	424	35
Rural community	211	55	105	8	445	40	797	65
Occupational groups	117	31	818	59	346	31	—	—
Other associations[b]			409	30	183	16	—	—
	382	100	1,374	100	1,116	100	1,221	100

[a]Credit unions are grouped according to the type of common bond. Caisses populaires, which do not apply the common bond principle, are grouped by location.

[b]Racial, religious, etc.

SOURCE: As for Table 9–1.

TABLE 9–3

DISTRIBUTION OF LOCALS BY SIZE
(END 1960)

—	CREDIT UNIONS				CAISSES POPULAIRES			
	No. of Locals	%	Total assets[a] $ millions	%[a]	No. of Locals	%	Total assets $ millions	%
Assets of								
$5 million and over	n.a.	n.a.	n.a.	n.a.	15	1	99	14
$1 million to $5 million	n.a.	n.a.	n.a.	n.a.	163	14	331	48
Sub total: $1 million and over	110	3	245	45	178	15	430	62
$½ million to $1 million	137	4	110	20	152	12	107	16
Less than $½ million	3,171	93	190	35	891	73	150	22
TOTAL	3,148	100	542	100	1,221	100	688	100
Average assets per local	$159,000				$563,000			

[a]Asset distribution is partially estimated.

SOURCE: As for Table 9–1.

lished a higher proportion have passed the million dollar line.

Most of the 4,700 caisses and credit unions are federated in 18 distinct, and sometimes rival, leagues. They have also established 27 central credit societies (or "central" departments of their leagues) for pooling some of their financial operations. While these leagues, centrals and other common activities integrate the network of locals in a number of important respects, each society is essentially independent and conducts its affairs in ways suited to its particular environment. Each is managed by its own board of directors and committees elected by and from the membership

and in most cases serving without pay. This democratic and local character follows naturally from the societies' co-operative organization—all depositors and borrowers must be members and have equal voting rights regardless of their shareholdings. It is also enforced by the broadly similar credit union legislation passed by all provinces. These acts restrict membership to a group having a common bond of association or living in a well-defined neighbourhood (which can be as large as a city). They also set out the duties of directors and management committees and limit or prohibit their borrowing from their society. Finally, most provinces impose a limit on the size of unsecured loans and restrict investment in securities, generally to types listed in trustee acts. In two provinces the legislation also establishes minimum liquidity requirements.

Both the size of a local society and the character of its membership influence its policies and manner of carrying on business. A relatively large local will probably have a modern office, professional management, trained employees and regular hours of business while a small one may operate with an unpaid treasurer conducting the business at odd hours on the corner of a desk. An urban society inviting membership from all residents of a heavily populated area will differ from one whose members are all employees of a particular firm or belong to an ethnic organization or to a co-operative in a farming community. Most, however, seem able to maintain the sense of involvement and interest of large numbers of their members, even though the bigger locals are of necessity more impersonal in their operations.

THE BUSINESS OF LOCAL SOCIETIES AND THE GROWTH OF THE MOVEMENT

The different attitudes of caisses populaires and credit unions towards borrowing by members have resulted in a striking difference in the structure of their assets, as shown in Table 9-4. Credit unions invest about 65% of their resources in loans to members, mainly for consumption purposes, although societies of the Antigonish type do a more diversified lending business in the communities where they are established. For instance, in Saskatchewan some 40% of their loans are to farmers for current operations and the purchase of equipment. The share of credit union funds devoted to mortgage loans has been quite stable in recent years: most of them are small short-term loans secured by mortgages rather than long-term residential mortgages but there has been increasing demand from members for housing finance.

Credit unions are limited to a 1% per month maximum rate on their loans in most provincial acts; their effective charges, after allowance for insurance benefits and the partial rebates of loan interest which are a regular part of the annual distribution of some co-operatives' income, range between 8% and 10% for most credit unions and a little lower for the larger ones and for rural societies. Most personal loans are secured by a chattel or real estate mortgage or by personal guarantees. The provincial acts usually set a limit

TABLE 9-4

COMBINED BALANCE SHEETS OF LOCALS[a]
(December 31, 1961)

	CAISSES POPULAIRES		CREDIT UNIONS	
	$ million	%	$ million	%
Assets				
Cash: Deposits at Centrals	111.0	13.2	33.4	5.1
Other cash	29.0	3.4	20.4	3.1
Shares of Centrals	6.5	0.8	23.0	3.5
Other Investments	246.5	29.4	49.8	7.6
Personal Loans	56.8	6.8	429.7	65.4
Mortgage Loans	346.5	41.3	83.5	12.7
Other Assets	43.4	5.2	16.9	2.6
TOTAL	839.8	100.0	656.6	100.0
Liabilities				
Borrowings and other Liabilities	2.7	0.3	29.7	4.5
Deposits	734.8	87.5	78.9	12.0
Shares	56.7	6.8	499.8	76.1
Reserves	38.1	4.5	25.4	3.9
Undivided earnings	7.6	0.9	23.0	3.5

[a]See the appendix volume for additional balance sheet data and sources.

varying from $200 to $500 on individual unsecured loans, which in total account for less than 10% of the amount of outstanding loans. Many societies charge the same rate on all loans, this being a rather surprising extension of their policy of equal treatment for all members in view of the variation in the risk, term and costs of administration of different loans. It seems particularly inequitable when the standard rate is charged for loans secured by the member's own shares and deposits.

In contrast to the credit unions, some of which have half of their members borrowing from them at any one time, only 10% to 15% of caisses populaires members are normally borrowers. Moreover, only one-half of their funds is invested in loans to members and most of these are conventional residential mortgages. The average term of these loans is thus a good deal longer than those of credit unions, a high proportion of which are paid off within a year of two. The rapid repayment of their loans provides credit unions with a steady inflow of cash which contributes to their aggregate liquidity, while the caisses with longer-term loans and a somewhat more conservative tradition lend less to members and carry much larger and more liquid security portfolios, either directly or through their centrals. They invest heavily in municipal issues, and in this market as well as in residential mortgage finance are the largest institutional participants in Quebec. Their wide network of locals enables them to meet the needs of small communities as well as the larger centres in both activities. The caisses have not attempted to offer the strong competition to other institutions in the personal loan market which has been typical of the growth of credit unions, although attitudes towards personal borrowing are changing. Interest rates are low, varying from 6% to 8% on the limited amount of such personal lending they have undertaken and being somewhat lower for mortgage loans. Quebec law does not prescribe a maximum value of unsecured personal loans although the by-laws of locals usually do.

Neither the credit unions nor the caisses populaires attempt to adjust the allocation of their resources in the short run primarily in response to the rates of return available on different assets, although their lending and investment policies do alter to keep attuned to the wishes of their members. Thus, the credit unions are beginning to shift into mortgage lending, either at the local level or through their central societies, and the caisses are becoming more interested in consumer loans. These trends are not rapid because of the commitment of both sides of the movement to the traditions of their origins. We do not, however, accept the view sometimes expressed to us that because they are not as concerned with yield as other lenders these societies have seriously misallocated their resources and those of the community as a whole. Their knowledge of their members has enabled them to make sound loans at favourable rates in areas of the market where demand has been strong, particularly the consumer credit and mortgage markets. Their continued growth will depend on their ability to meet the needs of their members on terms not out of line with those available elsewhere. These members are always free to turn to other lenders and no doubt are increasingly aware of these alternatives. We believe that changes in credit demand, the trend toward professional management and larger societies, and the rising dollar investment of the average member will combine with competitive forces to bring about a more conscious response of the movement to price considerations. This is in fact already happening in the centrals and in the more highly developed parts of the movement.

Credit unions and caisses populaires issue shares and accept funds in deposit accounts. All members must own at least one share, entitling them to a voice in the affairs of the local and to dividends from its earnings. Shares, normally valued at $5.00, may be purchased and redeemed on demand, although usually being nominally subject to notice of 60 to 90 days. However, among the caisses populaires large shareholdings are deliberately discouraged by charging a fee which is normally set at 2% but in some instances runs as high as 10%. As a result of this policy, the amount of outstanding shares is small compared

to the volume of deposits.[1] Caisses deposits are very much the same as bank savings deposits in that they are chequable and widely used as a means of payment, turning over around 2½ times a year compared to once every 15 years for shares. As with their shares, caisses populaires may require notice of withdrawal of deposits but do not in practice do so.

In contrast to the caisses populaires, credit unions draw most of their funds from the sale of their shares, which at the end of 1961 accounted for over three-quarters of their liabilities compared to only 12% in the form of deposits. However, a few societies limit each member to a single share and in these cases most of their liabilities are non-chequable deposits. The low annual rate of turnover of credit union shares, about once every two years, is evidence that they are not generally used by the members as a close substitute for chequing accounts. Indeed, accumulation of these shares often appears to be part of the members' longer-term savings programs rather than short-term savings. Credit union deposits, on the other hand, are for the most part chequable accounts in very active use, similar in this respect to the personal chequing accounts of the chartered banks and to bank current accounts of small family businesses and co-operatives. They turn over from 15 to 40 times a year and members of credit unions which offer chequing services are urged to use them rather than drawing on their share balances. We were told that it was usually not feasible for credit unions to offer such services unless their assets exceeded $200,000 and they employed skilled full-time help. Moreover, some provinces prohibit or limit chequing facilities and societies of the American tradition tend to oppose them on principle. The result is that only 10% of the locals offer such services, with the proportion being significantly above average in Saskatchewan and British Columbia.

Although the caisses populaires and credit unions have the power to enforce the notice requirements on withdrawal of shares and deposits and could do so to protect themselves against drains on their liquidity in unusual circumstances, this step is rarely taken. They prefer to borrow from their centrals when temporarily short of cash rather than run the risk of damaging their reputation with members by requiring notice. In the rare instances—involving perhaps a dozen or so local societies each year—when the notice provisions are formally invoked the society doing so is usually in more serious difficulty and this measure may well be part of a more far-reaching plan to set its affairs in order or, at the extreme, to liquidate it.

We do not have complete information on the size distribution of caisse populaire and credit union accounts. Sample information prepared for us suggests that the distribution is much the same as chartered bank personal savings accounts, with the important exception that the co-operative societies do not attract the very large balances held in a limited number of bank accounts. About 86% of accounts hold amounts of less than $1,000 compared to 84% in personal savings accounts. The caisses populaires have fewer small accounts and more large accounts than credit unions, although there is much variation between credit unions in different provinces.

While the amounts of credit union deposits and caisses shares have grown steadily, the success of these institutions in attracting funds has resulted principally from the rapid growth of the other two much larger classes of liability—caisses deposits and credit union shares. In Quebec, one-quarter of the population now appears to hold a quarter of all savings deposits in the form of caisses populaires deposits, while in the rest of Canada about 10% of the population are members of credit unions which hold less than 10% of savings, mainly in share form. The share of savings held in credit unions is lower in Ontario than in the Western Provinces, where there are fewer industrial societies and the community-based locals have been more effective in inducing savers to invest in their shares.

Although caisses deposits provide the same service as chartered and savings bank accounts,

[1] The policy was originally intended to prevent a few members from dominating a local by threatening to withdraw their large shareholdings. It also serves to sustain the dividend rate by keeping the amount of shares low in relation to income.

the interest paid on them is frequently higher; about one-third of the locals usually pay the same rate, but one-third pay ¼% more and the remainder ½% more. However, growth rates of different caisses do not seem to be closely related to these yield spreads. Dividends paid on credit union shares, which are subject to maximum levels in most provinces, are set by each society at the end of its fiscal year so that members do not know the exact return on their funds in advance. The rates vary considerably within a range from 0% to 6%, with a large number of locals paying about ½% over the banks' savings deposit rate. The effective return in some provinces is raised a further ½% or so by the inclusion of insurance coverage without an explicit charge. As with the caisses populaires, there does not seem to be a close association between dividend rates and the growth of individual societies, although a number of credit union officials referred to adjusting rates to keep them in line with rates available elsewhere.

In spite of this increasing concern with the competitive importance of the rates paid on funds, it seems clear that other factors have contributed more to the movement's success. Some of these, such as the location of offices, hours of business and the lending and other services provided for members, are forms of competition found throughout the financial system. For instance, caisses populaires are to be found in most Quebec parishes, no less than 500 of the 1,261 being located where there is no bank branch; this extensive network has brought caisses populaires within easy reach of the population. Similarly, the credit unions are conveniently located, many of them actually in the plant or office building where members work and —like caisses populaires—doing business at hours which suit the membership. Some of these credit unions have been further assisted by payroll deduction schemes and by employer donations of office space and, occasionally, office equipment. Moreover, the ability of the credit unions and caisses to offer mortgage and other personal credit at attractive rates to people who might well be considered less credit-worthy by institutions lacking such close personal knowledge of their character and financial position has undoubtedly put them in a particularly favourable position to profit from the strong post-war demands for funds in these markets. Finally, credit unions have for many years offered their members life insurance coverage on their share holdings and on loans: caisses populaires have begun doing so in the last decade, although they usually levy a specific charge for this service. The evidence is not clear, but many credit union witnesses stressed the importance of the insurance feature in attracting funds, and the fact that competing institutions are now using this feature more widely supports their contention.

All these factors serve to attract members and their savings, but the rapid growth of the movement has been based also on the special appeal of small co-operatives which offer their members a share in the management of a common venture. One should not exaggerate the strength of this sense of involvement because a high proportion of members do not in fact participate actively in the management of locals or even attend general meetings. Nevertheless, it is characteristic that the members feel more closely associated with their caisse or credit union than they do with a bank branch, believe themselves freer to discuss their finances with an officer of a local society, and have more confidence that they will get sympathetic treatment from them than from officials of larger and more remote institutions. In Quebec, nationalistic and other social forces may be a factor in the growth of the movement, but in all provinces it has been helped by the missionary zeal and education efforts of its organizers. The fact that some 50,000 people give their time without pay to their caisses populaires and credit unions is impressive evidence of the dedication and strong appeal which the movement engenders in its members.

The incomplete data which we have on credit union revenues and expenses must be used cautiously because of wide variations in the positions of individual societies. Gross income seems to be a little over 8% of average assets in most provinces, running up to close to 11% for smaller consumer-loan oriented locals, compared to average levels around 7% ten years ago. With

the exception of Saskatchewan, where the investment portfolio and deposit account charges provide about 30% of income, all but 5% or 10% comes from interest on loans. Administrative expenses now average about 2¼% of assets, which is about the same ratio as for the chartered banks, although the expenses of bank personal lending are no doubt considerably higher. The heavy reliance of small credit unions on unpaid help is an important explanation of their relatively low administrative costs in the personal lending business. Their costs are well below those of consumer loan companies which incur much heavier credit evaluation, processing and collection costs. The cost of insurance amounts to a further 1% of assets, leaving most societies with 4% to 5% for retained earnings and payments to members on their shares and deposits. For the few large societies charging the full 12% on loans, this return may run as high as 7% and in some locals where volume is small and unit costs high it may be as low as 2%.

Heavy investment in securities and mortgages rather than personal loans yields the caisses populaires a much lower gross income: in 1961 it amounted to 5% of average assets. Administrative expenses at 2.2% are about the same as for credit unions: the expense of administering assets is lower because they do less personal lending but this is offset by the cost of offering deposit service to virtually all members. Their expenses, like those of the credit unions which have broadened their services, have risen steadily in recent years. The return to caisse populaire members, including allocations to retained earnings, has risen relatively slowly from about 2¼% ten years ago to 2.9% in 1961.

We received many submissions that the caisses populaires and credit unions owe no small part of their success to the fact that as co-operatives they are virtually exempt from corporate income tax and therefore have an advantage over competing institutions which must pay taxes on their profits. While it has not been our job to examine the merits of this feature of the tax law as applying to all types of co-operative, we have considered its effect on the competitive position of the caisses populaires and credit unions. Dividends paid on their shares are in all essentials similar to the interest paid on deposits. Indeed the similarity is so close that if taxes were to be applied to this part of income the credit unions could comparatively easily alter the form of payment to their members so that it became in all respects a fixed interest cost deductible for tax purposes. Nor would this change the position of their members since earnings on credit unions shares are now taxable in their hands as interest. It would, however, pose some problems for the locals in forecasting their financial position to ensure that they did not pay out too much or too little of their earnings, a consideration that does not now arise since most returns are only determined after the results of the financial year are in. Thus, from the point of view which particularly concerns us—that of the competitive positions of different financial institutions—the practical effect of taxing dividends would not be significant. We are not therefore prepared to recommend such a change, especially in view of the fact that another Commission has under study the question of the taxation of co-operatives generally.

Thus the question of equity or competitive advantage relates only to the fact that retained earnings are not taxed. While this does give the co-operative institutions an advantage, much of the discussion suggests a greater competitive edge than in fact exists. The allocations to retained earnings have averaged about .7% of credit union assets and .5% for the caisses populaires. Since most of the earnings of locals are less than $35,000, the 21% tax rate would apply so that tax payments would average something between .1% and at most .25% of assets. They would therefore be able to meet the tax liability on all retained earnings and maintain the rates paid on deposits and shares unchanged by raising their lending rates relatively little. Since these rates are usually below, and often well below, those of competing institutions, the caisses and credit unions could presumably make this adjustment without undue difficulty.

However, even co-operative doctrine itself supports the view that retained earnings in excess of

allocations to specific reserves and current write-offs are in the nature of a profit. Such earnings are accumulated against unknown risks which may materialize in the future and benefit the members at that time at the expense of current users of the co-operative's services. We therefore recommend that the taxation rules regarding permitted reserves and retained earnings applying to caisses populaires and credit unions should be the same as those applicable to other banking institutions.

The present provincial legislation usually requires credit unions to allocate 20% of net earnings before dividends to reserves: most credit union locals meet but do not exceed this requirement. Caisses populaires reserves, governed by somewhat different rules, have averaged about 4.5% of total liabilities for some years; those of credit unions have been rising and are now close to 4%. These figures tend to overstate the true reserve position because the societies are frequently slow to write off loans and do not generally write securities down to market values. As small, local institutions they are not able to diversify their risks as well as larger intermediaries, but in most provinces they have set about meeting this problem by establishing "mutual aid" funds to meet difficulties wherever they may arise. This pooling of a part of contingency reserves in a common fund is a very valuable form of self-insurance but unfortunately does not yet cover all locals and is perhaps not being pursued aggressively enough in some areas. If the credit unions and caisses populaires have no alternative forms of insurance, it should be compulsory for all societies to join mutual aid funds, as it now is in British Columbia and Saskatchewan. Larger initial assessments should be drawn from existing reserves as well as current income. Reserves held in this form should be considered part of the reserves of local societies and the administration of the funds should be linked to an effective supervisory system.

RESPONSE TO MONETARY POLICY

Caisses populaires deposits are a close substitute for chartered bank savings deposits and are similarly affected by changes in interest rates and the availability of funds in the economy.[2] They have been growing a good deal more rapidly than bank deposits, but in periods such as 1956-57 and 1959, when the Bank of Canada was bringing pressure to bear on the financial system, the growth rate fell noticeably. Credit union shares, the main form of their liabilities, are more akin to longer-term savings and somewhat further removed from the area of price competition. Their very rapid growth rate varies from year to year and from one province to another for many reasons including surges of organizing activity, but also appears to have been reduced a little in periods of restrictive monetary policy. Because of the importance of special factors in the performance of different parts of the movement it is difficult to judge the influence of general monetary policy, but it is in any case much less pronounced than for caisses populaires. Credit union deposit business, while small, appears to be more sensitive to market developments than share business in provinces where it is most developed. For instance, in Saskatchewan deposits rose 9% in 1959 compared to 26% in 1958 and 23% in 1960.

It is worth emphasizing that the limited sensitivity to monetary policy shown by the credit unions does not stem from the fact that they do not carry cash reserves at the Bank of Canada but from the fact that funds flow to them in response to factors other than just prices and yields. Even if they were required to hold reserves at the central bank, their position would not alter since the initial effects of central bank action on cash reserves spread through the financial system in response to price and yield changes. The less important are price factors alone in the competition for funds, the weaker will be the initial impact of that action on any institution.

To the extent that these institutions, particularly the caisses populaires, do feel the impact of a restrictive policy on the growth of funds

[2] See Charts 2 and 3 in Chapter 11.

TABLE 9–5

ANNUAL PERCENTAGE CHANGES IN LIABILITIES

Year ending Dec. 31	All chartered bank deposits	Chartered banks' personal savings deposits	Caisses populaires[a]	Credit unions[a]
1951	− 0.9	2.9	13.1	23.4
1952	6.0	7.1	14.5	29.7
1953	5.4	3.4	9.1	30.0
1954	5.9	9.7	10.1	17.7
1955	11.2	8.0	16.8	19.6
1956	− 0.1	6.6	14.5	16.7
1957	4.3	4.0[b]	10.0	18.7
1958	11.8	12.0	15.4	23.3
1959	− 0.1	0.8	8.4	20.2
1960	6.0	4.6	9.9	19.3
1961	9.7	5.6	13.6	21.2

[a]Shares and deposits.

[b]Adjusted for a change in the definition of personal savings deposits.

available to them, they normally respond by cutting back on all types of lending and investment rather than by limiting their investment in liquid assets or selling securities. (There have been exceptions, particularly among the central societies, to this as to most generalizations about the caisses and credit unions.) Like most other institutions, the caisses and credit unions experience strong loan demand from members in a boom period and find that their supply of available funds is limited in relation to this demand. (In contrast, the sales finance and consumer loan companies are able to obtain the funds necessary to finance rapid asset expansion in such periods.) The movement tries to adjust to this pressure on its resources through the rationing of funds—by holding up lending approvals for a number of weeks,[3] by pruning down loan applications, and by discriminating against the larger borrowers. Attempts are also made to obtain speedier repayment of outstanding loans and, sometimes, to curtail lending to recent members who may have joined primarily to obtain credit they have been unable to get elsewhere. In periods such as 1956-57 and 1959, some centrals cushioned the strain on their locals by increasing their borrowing from chartered banks and, when their lines of credit were frozen, by selling securities to make funds available for locals to re-lend to their members. Some centrals also sent letters to their locals warning that funds were in short supply and advising them to be careful in their lending policy,[4] while some raised their own rates and in rare instances advised their locals to do so.

The centrals, which are the main link between locals and the rest of the financial system, play a leading role in guiding the response of the movement to changing credit conditions. This response is by no means as dramatic as that of many other institutions and has, particularly among the credit unions, been necessitated more by strong loan demand than by pronounced reductions in the growth of funds. Caisses populaires have, as we noted above, felt a more distinct decline in the growth of funds available to them and have normally adopted the policy of rationing the extra loan demand, their centrals restricting loans to locals at all times as a matter of policy and being if anything rather less willing to sell securities for lending purposes than are those of the credit union movement.

THE LINKS AMONG LOCAL SOCIETIES

Most of the preceding discussion has been about the business of local credit unions and caisses populaires. We come now to the interconnections among them which serve to integrate the independent societies into a system, or rather a number of regional systems. The majority of credit unions and all caisses populaires belong to provincial leagues. These associations have been established to carry on educational work, to promote the spread of credit unionism and to encourage the adoption of uniform standards of service. In the latter context, some of the leagues carry out inspections of the locals and have responsibilities for their supervision under various

[3] See for instance Transcript page 1019 (Manitoba), page 3229 (Ontario).

[4] See for instance Transcript page 224 (British Columbia), page 524 (Saskatchewan), page 1136 (Ontario), page 2260 (Nova Scotia).

working arrangements with the provincial authorities. There are at present 18 of these voluntary leagues, one in each of the provinces except Newfoundland and more than one in provinces where separate leagues of English and French speaking credit unions and caisses have been formed or where different groups have wished to emphasize particular features of the movement's tradition. Some of them, notably the Fédération de Québec des Unions Régionales des Caisses Populaires Desjardins which embraces most of the caisses populaires, are strong organizations providing many services to their member societies and serving to integrate their locals quite closely into a system with considerable uniformity of standards and procedures. In other cases, the leagues are much looser organizations. The individual societies are voluntary members which retain their independence and may at times be resentful of suggestions and directions from league officials. In a few provinces, moreover, significant numbers of local societies are not affiliated to any league.

There has been a tendency in some parts of the country for the societies to move into associated types of financial business. In Quebec, the caisses populaires control life and general insurance companies and have recently taken steps to enter the trust business. Except for the Saskatchewan group which has established its own trust company, the credit unions have not moved far in the direction of this sort of common action but it is probable that they will do so at some stage. The caisses populaires, which are a substantial part of the financial system in Quebec, have also entered into joint ventures with other institutions, notably by investing in the provincially-sponsored General Investment Corporation formed to finance Quebec enterprises.

The credit unions and caisses populaires have also established the central credit societies or central departments of their leagues referred to earlier. These provide a variety of banking services for the local societies. Although most centrals are not yet very large, some—particularly those established by the caisses populaires and three or four in provinces where the movement is most mature—are well established and are an important unifying force. The locals carry excess funds in deposit and share accounts at the centrals which in turn carry cash accounts with the chartered banks, re-lend to locals in temporary need of funds and invest the remaining pooled reserves of their locals in securities. Thus, as bankers for the locals, the centrals consolidate their liquid assets and provide the main pool of reserves for the system. They may also handle clearings for societies with transferable deposit accounts, although some locals run their clearings through their own chartered bank accounts. Moreover, they buy and sell securities for locals and in general act for them in their relationships with other parts of the financial system in the ways indicated in the preceding discussion of monetary policy. Three or four of them also offer a fairly complete banking service to other co-operatives and some lend to members when the type or size of accommodation needed out-runs the resources or capabilities of their local societies.

There is a striking difference in the policies of caisses populaires and credit union centrals. The

TABLE 9–6

COMBINED BALANCE SHEETS OF CENTRALS
(December 31, 1961)

—	Caisses Populaires Centrals		Nine Credit Union Centrals[a]	
	$ mn	%	$ mn	%
Assets				
Cash	41.8	34.3	5.7	8.0
Loans—to local societies	1.9	1.6	20.6	29.0
—to others	3.2	2.6	15.8	22.3
Investments	72.9	59.8	27.7	39.0
Other Assets	2.0	1.6	1.1	1.6
TOTAL	121.9	100.0	71.0	100.0
Liabilities				
Bank Loans, etc.	—	—	4.2	5.9
Deposits of locals	111.0	91.1	34.3	48.3
Shares of locals	6.5	5.3	23.7	33.4
Other shares and deposits	0.1	0.1	6.0	8.5
Reserves	3.6	3.0	2.1	3.0
Undivided earnings	0.6	0.5	0.5	0.7

[a] These nine centrals on which full information is available have more than 90% of the assets of all centrals. See the appendix volume for details.

former accept funds only from the local caisses and as a matter of policy invest nearly all of their resources in cash and securities, lending very little to the locals which, as noted above, maintain cash and investments equal to about one-half of their resources. Although the centrals' investments include substantial amounts of municipal issues which are not readily marketable, the caisses are highly skilled appraisers of such securities, their average term is short and the centrals are in a highly liquid position. Securities are not normally traded extensively although the centrals usually act as agents for their locals in their purchases and sales. Credit union centrals, on the other hand, accept funds from and lend to other co-operatives as well as their locals and invest a much lower share of their resources in cash and securities and a higher share in loans to the local societies. Security dealings of the locals are not nearly as centralized as those of the caisses and holdings of both centrals and their members are generally longer in term and less marketable, although some centrals are making a conscious effort to shorten portfolios and increase their marketable investments. Thus, while credit union locals rely on their centrals as a temporary source of funds to a much greater extent than do the caisses, the centrals themselves are in a less liquid position.

We have shown the combined balance sheets of the locals and of the centrals separately in order to comment on their different functions. A consolidated statement, in which the claims of locals and centrals on each other have been netted out and which differs in this respect from hitherto published data, brings out quite clearly the difference in the asset structures of the caisses populaires and the credit unions.

The consolidated position of the caisses populaires at the end of 1961 shows cash reserves of just over 8% in the form of Bank of Canada notes and chartered bank deposits as well as 38% of assets invested in securities, while about one-half of the assets were mortgages and other loans to members. On the other hand, the consolidated credit union balance sheet reveals that they had lent 81% of their funds to members,

TABLE 9–7

CONSOLIDATED BALANCE SHEETS OF LOCAL SOCIETIES AND CENTRALS[a]
(December 31, 1961)

	Caisses Populaires		Credit Unions	
	$ mn	%	$ mn	%
Assets				
Cash	70.9	8.4	25.2	3.9
Investments	319.4	37.9	76.8	11.8
Loans to members	421.8	50.1	529.0	81.5
Fixed and other assets	30.1	3.6	18.0	2.8
TOTAL	842.2	100.0	649.0	100.0
Liabilities				
Bank loans and other liabilities	0.7	0.1	13.3	2.0
Shares and deposits	791.6	94.0	584.6	90.1
Reserves	41.7	5.0	27.5	4.2
Undivided earnings	8.2	1.0	23.5	3.6

[a]Only the nine centrals shown in the previous table are included.

held investments of 12%, and cash of 4%. These statements appear to be representative of the normal situation of the caisses populaires and the credit unions since the structure of their assets does not vary much. These figures bring out sharply the tendency of the credit union movement to operate with relatively low cash reserves and security holdings compared to the much more conservative policy of the caisses populaires. An earlier table showed that credit union locals themselves had cash reserves in excess of 8% and investments of about 11% but that more than one-half of the cash was in deposits at centrals and about a third of investments was in central shares. Thus, the locals rely heavily on the centrals for their liquidity, while they in turn, as we have seen, tend to maintain a relatively low cash and liquid asset position.

There is, of course, nothing unsound in the establishment of central societies to pool the liquid resources of locals and provide other services for them: indeed this development contributes much to the strength, cohesion and flexibility of the credit union system. However, in view of their position as specialized bankers to local societies, which because of their similarity

may well be subject to pressure on their resources at the same time, the centrals must pay close attention to their ability to meet whatever demands the locals may make on them. In spite of their excellent record and the fact that both locals and centrals can and do borrow from chartered banks when need arises, the low level of liquidity maintained by credit union systems in some parts of the country raises questions about future developments. As long as the movement grows rapidly, liquidity needs are in effect met by the inflow of new funds. However, if the growth rate were to drop at all suddenly because of a change in the competitive situation, because the fringe of potential new members shrank or disappeared, or because of increased sensitivity to general monetary policy, serious liquidity problems might develop. We do not see this as a present danger and wish to emphasize that credit union policies have not proved unsound in the circumstances prevailing to date. Nevertheless, we believe steps should be taken to ensure that these institutions are prepared for a change in the weather. We do not think a reasonable concern for overall liquidity need lead to any serious impairment of future growth.

The process of consolidation of the credit unions and their liquid resources is carried a stage further under the Co-operative Credit Associations Act, the only federal law respecting credit unions. This was passed in 1953 in order to remove any doubts about the constitutional position of the provincial centrals[5] by permitting them to register under a federal act, and to establish a national central, The Canadian Co-operative Credit Society Limited. Membership in this society, which is supervised by the Superintendent of Insurance, is limited to central co-operative associations declared eligible by Parliament and approved by Treasury Board, a maximum of 10 co-operatives other than credit unions and 15 individuals.[6] The society has not been very active: only four provincial centrals have taken out membership and their investment in its shares and deposits has not been large. Societies belonging to this national central are required to maintain cash reserves equal to at least 5% of their deposits and to hold a further 20% in cash and federal, provincial, municipal or school securities. They are also limited to issuing liabilities up to 10 times their capital and surplus and may not lend more than 10% of their funds to one member except for short periods, with "adequate" security and on the approval of two-thirds of the directors.

The fact that some of these restrictions are more severe than those in the provincial legislation and that many of the Act's provisions are inappropriate to the needs of the credit union movement accounts for the general lack of support of the C.C.C.S. In our view it is unnecessary to create a third tier in the pyramid of locals and centrals and undesirable to do so without adequately assuring the liquidity of the entire system. The present Act sets minimum liquidity standards for the members of the national society—which are the provincial centrals—without regard to the cash and liquidity needs of all the locals which belong to them. It is somewhat as if one tried to base a judgment of a bank's liquidity needs on the position of its head office without regard to its branches, although the parallel is of course not precise because credit union locals are independent entities, not branches of a single organization. Moreover, the investment and membership restrictions and limitations on capital ratios and loan size do not seem entirely relevant to credit union operations. We will put forward proposals later in this chapter to replace this Act with legislation more attuned to the character and needs of the credit union movement and the public it serves.

The basic job of protecting the public in its dealings with credit unions and caisses populaires is done not at the federal level but by the provinces. Each of the provincial credit union acts provides for a system of inspection and supervision. In all provinces except Prince Edward Island, where the league is formally responsible, and Quebec, where the law is unclear, a govern-

[5] Evidence of the Superintendent of Insurance: Transcript, page 6882.

[6] Provision was made for members other than centrals to join in order to enlarge the capital base of the new organization and enlist the support of a broader group in the co-operative movement.

ment agency is responsible for the supervision of credit unions. Paradoxically the caisses populaires have adopted the most thorough inspection procedures in spite of the fact that the Quebec legislation does not provide for any clear government responsibility in this area. One of the main purposes in establishing the Federation of Caisses Populaires in 1933 was to improve the supervision of locals, and the Federation now has a highly qualified inspection department with over 100 full-time professional employees, with each inspector carrying out an average 20 inspections a year. Methods are modern and efficient, surprise audits are used, and all findings are discussed with local management and committees. The calibre of the personnel has ensured a high standard of supervision by people thoroughly familiar with the business but in the absence of a clear delegation of authority by the government the continued adequacy of supervision depends on the willingness of the independent local societies to submit to inspection and to accept the advice and, when warranted, the reprimands of the Federation. The final responsibility of government might be further clarified in view of the difficulties that could develop if local officials became stubborn or if the inspectors were to abuse their ill-defined authority.

In other provinces where the governments are responsible for supervision, the supervisory staff is not always equal to the task expected of it. In some provinces the staff has expanded with the growth of credit unions but in all cases it is much more heavily burdened than the caisses populaires inspection department. In British Columbia, for example, we were told that one inspector and two assistants were responsible for no less than 326 local societies. Moreover, members of some provincial staffs do not devote all their time to inspections for they are frequently expected to do other work in connection with credit unions. In some provinces, inspections are regular and reasonably thorough but in others the staff is so small relative to the number of credit unions that it is not possible to carry out frequent or adequate inspections; in at least one province inspections are carried out only once in over two years. The problem is most severe in the case of smaller locals since a number of provinces require that societies over a certain size employ outside auditors to review their financial position each year. Understandably perhaps, provinces have been slow to incur the costs of expanding their credit union departments for, unlike the situation in the United States, it is they and not the credit unions which pay the bill. The caisses populaires receive a government subsidy for their inspection services but the Federation itself bears about 85% of the cost.

The leaders of the credit union movement are conscious of the dangers inherent in the present situation and some of them have indicated their willingness to contribute to the expenses of more adequate supervision. Some supervision is undertaken at the local level by supervisory committees elected by the annual meetings for this purpose but we were told they do not work effectively in a great many cases, largely because members of the committees have neither the training nor the time to do a thorough job of supervision.[7] In recognition of these facts, some leagues have taken the lead in supplementing the work of government and local officials by carrying out their own inspections and by encouraging or requiring larger societies to employ outside auditors. In addition, some centrals require full reports from member societies before they will lend to them. These are commendable steps indicative of the growing responsibility and maturity of senior credit union officials but they need to be integrated with a more complete system of inspection.

SUMMARY AND RECOMMENDATIONS

The caisses populaires and credit unions are now well past the initial stages in their development and are substantial and valuable members of the Canadian financial system. Their rapid growth is striking evidence that a great many people have found local co-operative societies able to meet some of their financial needs better

[7] Transcript pages 2233 ff and para. 101 of submission of the Nova Scotia Credit Union League. Transcript page 3634.

than other financial institutions and that the caisses and credit unions have served them well.

We believe, however, that a number of steps must be taken to ensure the continued sound development of the movement. Our recommendations do not involve new departures so much as the adoption throughout the credit union and caisse populaire systems of measures already introduced in many provinces by the authorities or by the movement itself. In framing our recommendations we have been careful to recognize that these institutions make a particular contribution to the financial system in large part because of their local character and adaptability to differing circumstances across the country and that it is therefore desirable to preserve as much local initiative and independence as possible.

Earlier discussion in this chapter has brought out the areas where latent weaknesses exist—the inadequacy of supervisory and inspection arrangements in some parts of the country, the need to strengthen the protection provided to shareholders and depositors by mutual aid funds, and the problems posed by the low liquidity of some credit union locals and their centrals. In each case our aim is to strengthen credit unions and caisses populaires so that their financial condition may fully justify the confidence which members place in them.

Before summarizing these main proposals, we wish to recommend that steps be taken to improve the published statistical information covering this part of the financial system. There is no reason why considerably more than the annual data prepared by the Department of Agriculture—which should be relieved of responsibility in this area—cannot be published. Monthly statistics are prepared by caisses populaires leagues for internal use and the same could be done by the credit unions for a large part of the movement.

Although the local credit unions and caisses populaires are, as we shall argue later in the report, banking institutions and as such might be brought under federal regulation, and although they asked for such regulation in the early part of this century, we agree with spokesmen for the movement that it is not now necessary or desirable to do so.[8] As relatively small, local and independent societies they can be regulated more efficiently by the joint efforts of provincial governments and officials of their own leagues who are thoroughly familiar with their methods and with the special problems they may encounter. However, the scope of this specific exemption from direct federal regulation should be restricted to local societies and should be conditional on the provincial authorities accepting full responsibility for supervision. In our view, it is essential that provincial staffs be adequate for the job and that when a province chooses to delegate part of the work to leagues or centrals its ultimate responsibility for inspection of local societies remain clear. All locals should be examined at least once a year, and more often if necessary, and the examining body should have the power to correct unsound lending practices. The authorities should also discourage the establishment of locals unless there is reasonable assurance that the founding group will be able to attract a sufficient pool of funds to constitute a viable society.

Leagues or centrals should be encouraged to continue to share in the work of inspection in order to take advantage of their expert knowledge and heighten their concern for the healthy growth of the movement. Indeed, we believe that expert and intelligent self-regulation under the final authority of government will best serve the needs of these societies, assuring that the interests of their members will be protected while avoiding the rigidities inherent in detailed and inflexible government regulations about investment and other powers. We believe also that the movement itself ought to pay more of the costs of inspection, as is now the practice with the caisses populaires and other institutions. Whenever part of the job is delegated in this way, it must be made compulsory for all locals to belong to whatever organization carries out the supervision for government, be it a league or a central. We will recommend below that locals should in any case belong to a central, whether or not it has supervisory responsibilities.

[8] Transcript, page 3148.

We agree with the views of the national organizations that all locals should also be required to belong to a mutual aid fund in order to provide an additional safeguard for their members.[9] As we pointed out earlier, credit unions and caisses populaires differ from other banking institutions accepting funds from the public in that they are restricted to operating locally and cannot diversify their lending risks as easily as other organizations operating over a broader area. They are thus especially vulnerable to severe local difficulties, and the assurance of help from the movement's own mutual aid funds is vital to them and to their members. If a more general system of deposit insurance were to be adopted in Canada, the mutual aid funds should be free to join it if they wished, although we believe it desirable in the movement's own interest that the primary source of insurance come from within its own ranks.

We turn now to our recommendations on the liquidity of the credit union and caisse populaire systems, a matter which concerns the centrals as well as the local societies. Whereas we think it desirable to leave the responsibility for mutual aid funds and direct supervision of locals with the provinces, we believe that the centrals should be brought into a national system of regulation since they are the bankers to their member societies and the principal links between the locals and the financial system of the country as a whole. Each central should be required to maintain adequate cash reserves in relation to its own liabilities and the liabilities of its member societies. Moreover, in order to integrate them more fully into the financial system and give them access to central bank credit when need arises, they should hold these cash reserves at the Bank of Canada.[10] As part of this framework of regulation, all locals should be required to belong to a central, preferably by provincial law, in order to ensure their access to temporary funds outside their own resources if their liquidity position is threatened. At the same time, the federal government should meet its responsibility for a sound banking system by examining and supervising the centrals to see that they are in a position to meet their locals' needs.

Having subjected them to meaningful cash reserve requirements and to uniform inspection and supervision, the laws should not unduly restrict the activities of centrals. In view of their position as specialized banks to the co-operative movement, they should be limited to issuing liabilities to credit unions, other co-operatives and public bodies specified in the legislation. This will serve to keep them focussed on their main job of managing the credit union and caisse populaire liquid resources. However, on the other side of their balance sheet, there is no reason to restrict their investment powers unduly provided that the federal supervisiory authorities are satisfied that their liquidity is adequate for their responsibilities.

Under the approach which we envisage, the credit unions and caisses would be free to form whatever national associations they wish, but the Canadian Co-Operative Credit Society would not function as the pinnacle of a three-tiered system of locals and centrals. The provincial or other regional centrals are and would remain the logical point at which to regulate and supervise the movement's liquid resources if one wishes to reconcile the national interest with the maximum of local flexibility and freedom for individual societies. These centrals would thus be brought into direct contact with the central bank and the federal banking authority. The Superintendent of Insurance could be relieved of responsibility for their supervision, a task which is in any event not closely related to his main functions.

The credit unions and caisses will no doubt continue to evolve and change, to become larger in size and more professional in operation, and to be more and more subject to market forces as a result of growing competition and narrowing earnings spreads. Yet we feel their emphasis will always be coloured by their wider social objectives of encouraging thrift, rehabilitating the financially improvident through the sound use of credit,

[9] Transcript, page 3158.
[10] See also the discussion in Chapter 19.

and giving priority to the smaller borrower who cannot turn elsewhere at reasonable rates. While naturally anxious to see the interests of the whole community safe-guarded, we have been no less concerned to ensure that the caisses populaires and credit unions are as free as possible to continue serving the local and special needs of their members in the spirit of co-operation and self-help which has been so largely responsible for their development.

CHAPTER 10

TRUST AND MORTGAGE LOAN COMPANIES

The earliest ancestors of the mortgage loan companies bore a close resemblance to the caisses populaires and credit unions of today in that they were mutual associations pooling their members' funds for a common purpose. Established like the Quebec Savings Banks in the 1840's, their aim was to lend to those wishing to build homes rather than to make personal loans or invest in securities. These early building societies were "terminating", winding up when each member in turn had taken out and repaid his building loan. In 1855 the first "permanent" society was established, and subsequent legislation clarified the powers of such continuing companies to borrow generally from the public. The mortgage loan companies have since remained in the same specialized business of borrowing by way of debentures and deposits and placing most of their funds in residential mortgages. Trust companies developed more recently, the first one having been incorporated in Ontario in 1882. They carry on an intermediary business similar to that of the loan companies, although placing less emphasis on mortgage lending and more on security investment, but differ from them and other institutions in having the right to act as trustee for property interests and to conduct other fiduciary business. Thus the Canadian trust company is a hybrid, being part administrator managing a great many separate trust and agency accounts and part financial intermediary handling a single pool of funds.

The trust and loan companies have been substantial members of the financial community since their establishment, but rapid expansion and extensive diversification of their activities have brought them new prominence in recent years. Their intermediary business has always been sizable, and from their earliest days has been exceeded only by that of the banks and insurance companies. In the 1920's they carried about one-half of the mortgages held by private intermediaries, and in the areas of the country where they operated they competed very successfully with the banks for savings. However, during the 1930's and the war years they lost position relative to the banks and other savings institutions. This resulted from the weak demand for mortgages, from the fact that they were not then particularly suited to play a major role in war finance, and from their own conservative reactions to the events of the period following the stock market crash of 1929, during which both they and their trust clients suffered serious losses. Their change of attitude and the dramatic growth of their intermediary business since 1945 thus stands out particularly sharply, while the substantial post-war increase in their traditionally important estates, trust, and agency business has contributed further to the renewed attention which the trust companies have been attracting. The fact remains, however, that it was not until the early 1960's, when the trust companies grew particularly vigorously, that the ratio of their size to that of the banks surpassed 10%, the

TABLE 10–1

GROWTH OF TOTAL ASSETS

—	Trust Companies[a]			Mortgage Loan Cos.			Chartered Banks[b]	
	$ millions	average annual rate of growth	% of bank assets	$ millions	average annual rate of growth	% of bank assets	$ millions	average annual rate of growth
		%			%			%
1935	225	—	8.9	230	—	9.1	2,514	—
1945	266	1.7	4.4	235	0.2	3.9	5,997	9.1
1950	441	10.6	5.6	367	9.3	4.6	7,918	5.7
1955	714	10.1	6.8	570	9.2	5.5	10,440	5.7
1960	1,284	12.5	9.8	945	10.6	7.2	13,121	4.7
1962	1,877	20.9	12.6	1,286	16.7	8.7	14,848	6.4

[a]Intermediary business only: does not include estate, trust and agency funds—(E.T. & A. business).

[b]Canadian and net foreign assets, excluding items in transit.

SOURCES: Dominion Bureau of Statistics and Bank of Canada.

level at which it had stood at the beginning of the 1930's. The loan companies, which were as large as the trust companies three decades ago, have grown less over the period as a whole despite their rapid gains since the end of the war.

In the course of this recent expansion, the trust and loan companies have come into increasing competition with the banks. Indeed, the willingness of these companies to become more competitive has been one of the main factors in their growth. On the savings side, they have opened new branches, tailored their liabilities with considerable skill to the preferences of individuals and others, and used higher rates and improved services to attract both personal chequing accounts and time deposits, the latter from a wide range of businesses and other organizations as well as from individuals. This competition comes mainly from the trust companies which on the lending side, too, have impinged increasingly on the banks' business even though they are not allowed to make unsecured commercial and personal loans. Instead, they have taken advantage of lending opportunities in the expanding money market and have become increasingly active term lenders through the purchase of short, medium, and longer-term securities. The strong post-war demand for mortgage funds, particularly against conventional mortgages—a field from which the banks are precluded—has however been the main underlying factor contributing to the growth of both loan and trust companies. The latter's non-intermediary business has benefited from the increase in public wealth, the spread of pension plans, and the growing complexity of investment and property management. More and more of this business is being turned over to trust companies because of their special knowledge of legal, estate-tax, and investment matters, and because their standards of performance and efficiency have risen.

The favourable environment that the industry has recently experienced has reversed the earlier tendency for mergers and acquisitions to shrink the number of companies. While at the turn of the century there had been about 100 firms in the industry, over 80% of them loan companies, by the mid-1950's this number had fallen by almost two-thirds. Most of the firms were by then trust companies, as many institutions which had begun as loan companies found it advantageous to acquire trustee powers as well. Moreover, a number of the major loan companies are now closely affiliated with trust companies, effectively operating in some instances as a single

unit. Within the last decade, however, despite some further amalgamations, the expanding opportunities in both industries have led to an increase in the number of companies and there are now some 25 loan and 35 trust companies dealing with the general public. Most of them are local despite the tendency for larger units to emerge: all but 14 have offices in one or two provinces only. However these larger companies have some 170 of the 270 or so trust and loan company offices and do a high proportion of the business.[1]

The industry is quite highly concentrated, particularly in the E.T. & A. business where the 10 largest companies have over 90% of the funds under administration and two companies alone have more than 50%. In the intermediary business, a slightly different group of 10 trust companies has about 75% of company and guaranteed funds, with the largest company having 15% of the total. The loan companies' business is more highly concentrated, the largest five having the vast majority of assets. Taken together, the 10 largest loan and trust companies have 60% of the intermediary volume, the largest firm—a loan company—having just over 10% of the total.

Loan companies run to a pattern in that they all concentrate on mortgage investment, but there is considerable diversity among the trust companies. Some—particularly those which have evolved from loan companies or which have been set up primarily to undertake mortgage lending and manage real estate—are in effect mortgage companies with trustee powers. Other trust companies give more emphasis to bond investment while some stress activities in the short-term market. Some companies rely heavily for funds on various kinds of deposits while others do not accept deposits at all.[2] Finally, some trust companies do a substantial estate, trust and agency business while others prefer to stress their intermediary activities, including those which come closest to banking.

This diversity, which is considerably greater than that of the banks, has been achieved despite the existence of legislation which is quite restrictive in some respects. The companies have been willing to experiment as much as these limits will allow and have obviously not been greatly hampered by legal restrictions in the recent past. The early legislation was enacted by the provinces and, although the federal government also chartered a number of companies by special acts it never made any move to regulate the banking side of the industry's activities. In 1914, however, federal legislation dealing with trust and loan companies as such was passed, and since then the companies have been able to choose between federal or provincial incorporation and regulation. The majority of the companies are in fact under provincial jurisdiction and the five loan and ten trust companies which are federally incorporated must be licensed to operate in each province, just as companies from one province must be registered for business in the others.[3] Moreover the estate, trust and agency business of all trust companies, being a matter of property and civil rights, is entirely subject to provincial jurisdiction.

In spite of the many differences in detail, the character of the various provincial laws is essentially similar. Moreover, since most companies operating in more than one province do business in Ontario and must therefore register under the Ontario Act, or are incorporated under the Ontario Act itself or the quite similar federal legislation, there is more uniformity in practice than the number of different laws might suggest. However, as the industry told us, progress towards uniform legislative standards in different juris-

[1] In some provinces, offices may only be opened if the supervising authority deems it to be necessary in the public interest, and this power has on occasion been used to limit branch opening. We do not regard such checks on competition as desirable. See our views on bank branching in Chapter 7.

[2] One very large company, for example, entered the deposit business only in early 1964.

[3] At the present time all provinces but Newfoundland and Prince Edward Island have trust company legislation either in separate acts, as a section of the Companies Act (Manitoba) or in a combined Trust and Loan Corporations Act (Ontario). Provincial loan companies are incorporated in the same way as trust companies in Ontario and Manitoba, under separate loan companies acts in Nova Scotia and Saskatchewan, and under the general companies legislation or by special act in the other provinces.

dictions is slow. Under most legislation, loan companies may accept deposits from the public or borrow by issuing debentures, while trust companies—by extension of their fiduciary powers—may accept funds in trust deposit accounts and issue "guaranteed certificates" or "guaranteed receipts". The legal distinction is that the funds held by trust companies are backed not only by a general claim on their assets, as in the case of most other financial institutions, but by specifically segregated and ear-marked assets. For this reason, their accounts must distinguish between the assets held against "company funds"—that is capital and reserves—and the assets in which "guaranteed" funds are invested. However, the fact that the funds are legally held in trust rather than borrowed does not make any practical difference to the trust companies or the financial system: the economic effects of their intermediary operations are the same as those of loan companies, banks and other institutions and the business is carried on in a similar way.[4] We therefore feel justified in referring to trust companies "borrowing" funds in spite of the legal inaccuracy of this term when applied to the guaranteed accounts.

The laws governing the trust and loan companies are unique in that they impose a minimum ratio of capital to liabilities. Thus the federal acts limit the amount of a company's deposits and debentures or certificates to 12½ times its capital, reserves and surplus, while in Ontario only the loan companies are subject to the same legal limit although it is also applied in practice to trust companies. Trust and loan companies in Nova Scotia are subject to a ratio of 10:1 and in Saskatchewan to one of 5:1.[5] These capital requirements have been gradually liberalized over the years from an original ratio of 1:1 on deposits and 4:1 on other liabilities in the Ontario Act.

Some firms have found these ratios confining despite the fact that the actual ratio for the loan companies combined was only six times in 1962: for the trust companies it was just nine times. They have accordingly suggested adoption of a uniform ratio of liabilities to capital of 15 to 1, which would require them to maintain capital, reserves and surplus of at least 6.25% of total funds less cash holdings. While we will reserve a full discussion of the usefulness of minimum capital ratios for a later chapter, it is worth noting here that it is all but impossible to prescribe by law what ratio is adequate to protect the companies' creditors against the risk of loss, to ensure that the owners have a sufficient interest in the successful management of their business, and—in the case of trust companies—to protect their trustee clients. Capital needs vary widely from company to company and are related to their size and to the character and diversity of their assets. Equity sufficient to meet the needs of one company might be quite inadequate in another, while conversely a requirement high enough for one might impose unnecessary penalties on another.

Turning to the asset side of their business, the loan companies are not subject to a legal cash ratio as are the banks. However, they are required by the Ontario law to hold cash and "liquid" assets equal to at least 20% of deposits and—an unusual feature—may not borrow this liquidity from the banks; British Columbia sets a minimum of 25%. However, liquid assets are so broadly defined—they include all federal, provincial and municipal securities—that most of the companies run well in excess of this rather meaningless requirement[6]. The acts also allow trust and loan companies to invest in a specified list of assets, in the manner of the Quebec Savings Bank Act, rather than adopting the Bank Act approach of permitting all investments not

[4] Transcript pages 3291, 3393-4.

[5] The formulas are a little more complicated for they also take account of cash holdings in arriving at the maximum borrowing levels. In Ontario, loan company deposit and debenture borrowing may not exceed the sum of cash and four times unimpaired capital and reserves (including undisclosed contingency reserves), the Lieutenant Governor-in-Council having the power to raise the capital factor to twelve and one-half times. New companies are generally held to the four times ratio but it is raised gradually to the maximum level as they become established and grow.

[6] The Trust Companies' Association of Canada, to which the 28 leading companies belong, is studying this question in line with its principal aim of maintaining and fostering high standards of industry management.

specifically prohibited. The effect is to permit purchase of a broad range of assets, including the conventional mortgages which are prohibited to chartered banks, but to prohibit unsecured commercial and personal lending even to the limited extent allowed the savings banks by the recent amendments to their act.

The acts usually prohibit loans to directors and also cover such matters as initial capital requirements (in Ontario the legal minimum is $300,000 of which $100,000 must be paid-up, but in practice the requirements are usually $500,000 and $250,000 respectively). The legislation also deals with audit requirements and supervisory arrangements. Because the companies are incorporated under many different acts and must abide by the law of each province in which they work, the present supervisory arrangements are somewhat complicated. The federal Superintendent of Insurance inspects the federally incorporated companies and, by arrangement with the provinces concerned, those incorporated in Nova Scotia, New Brunswick and Manitoba. Ontario reserves the right to inspect all companies registered to do business in the province as well as its own incorporations, but in practice accepts the federal Superintendent's inspections and those carried out by Quebec for companies chartered by the Quebec legislature. Similarly, while Quebec inspects its own companies, it accepts the work of the Ontario and federal authorities for other companies operating in the province. There is necessarily a good deal of overlapping among these three supervisory authorities even though in practice they often arrange to split the work of examining one company.

Most of the companies come under one or other of these authorities and are examined at least once a year. In Ontario, which has the most thorough system of any province, they must file lengthy annual statements and the same is true of companies inspected by Quebec and Ottawa. Inspection of the intermediary business is centred on verifying that the companies' capital position and assets meet the requirements of the law. It is backed up by power to write down the value of assets which are held to be overvalued, to call for full information from the companies and their auditors, and if necessary—to suspend a company's license to do business. Supervisory authorities do not examine the E.T. & A. business at all closely, although Ontario does spot check a certain number of accounts each year. The main burden of supervising the trustees falls on the courts which review their accounts periodically in provinces other than Quebec: in these provinces a trustee cannot collect his fee for an account until it has been passed by the courts.

The activities of these three separate supervisory authorities and the requirements of the three different acts raise problems for the companies which must satisfy them all. While far from perfect, supervision is much more thorough than in those provinces outside Quebec and Ontario which are not inspected by the Superintendent of Insurance. For instance, in Saskatchewan and Alberta there is no inspection of local companies, and although there is provision for it in British Columbia, we were told that it is not consistently carried out. In their evidence before us, spokesmen for the industry referred to supervision as being "nominal" in some provinces, and said that they would "welcome in certain provinces a stronger regulatory body than exists".[7] They also strongly urged that the legislation and supervision under which they operate should be uniform in all provinces.[8] Some spokesmen for the industry expressed the view that federal jurisdiction over the intermediary side of the business would be desirable, but one witness argued the case for provincial jurisdiction on the grounds that trustee matters are clearly a matter of property and civil rights.[9] We return to this general topic in Chapters 18 and 19 when we discuss the banking institutions as a whole.

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[7] Transcript, pages 3293 and 3282.

[8] Transcript, pages 3282, 3290.

[9] Transcript, pages 3278, 3281. See also the submission of General Trust of Canada which argues for exclusive provincial jurisdiction over trust companies.

THE INTERMEDIARY BUSINESS

1. *Loan Companies*

In spite of the similarity in the laws governing trust and loan companies, the latter have chosen to give their business a sufficiently different character and emphasis to warrant separate discussion.

The mortgage loan companies obtain most of their funds from the sale of debentures, which accounted for two-thirds of their liabilities at the end of 1962, and invest about three-quarters of their funds in mortgages and agreements of sale. The share of debentures in total liabilities has risen substantially in recent years, while a declining share of the companies' funds has come from both deposits and capital and reserve accounts. The bulk of their assets are of medium and long term, and the loan companies have preferred to borrow mainly at comparable maturity dates rather than by short-term deposits in spite of the higher interest cost of doing so; the rate disadvantage is, however, offset in part by the lower administrative expenses of debentures. The relative decline in capital accounts is associated with the easing of minimum capital requirements discussed earlier, and with the enhanced ability to operate on lower equity ratios as larger scale operations have increased the diversity of assets and reduced the risks of loss. Loan company deposits, which are not issued by all companies, are nearly all held by individuals.[10] Most of them are chequable, although some companies have begun to accept funds in non-chequing accounts at a slightly higher rate during the past few years. Clearing arrangements are made with the chartered banks.

Most debentures are issued with maturities of from one year, the minimum term allowed in Ontario, to ten years. Shorter-term debentures have been issued by one or two companies, and at the other extreme one important institution

[10] Submission of the Dominion Mortgage and Investments Association, paras. 37-39, 43.

TABLE 10–2

MORTGAGE LOAN COMPANIES
(December 31)

	1945		1950		1955		1962[a]	
	$ mn	%	$ mn	%	$ mn	%	$ mn	%
Assets								
Cash	9	3.8	16	4.4	18	3.2	24	1.9
Securities:								
Govt. of Canada	60	25.5	44	12.0	55	9.6	100	7.8
Provincial	7	3.0	7	1.9	12	2.1	31	2.4
Municipal	3	1.3	5	1.4	8	1.4	8	0.6
Corporate[b]	21	8.9	29	7.9	36	6.3	95	7.4
Mortgages	124	52.8	255	69.4	427	74.9	981	76.3
Other Assets	11	4.7	11	3.0	14	2.5	49	3.8
TOTAL	235	100.0	367	100.0	570	100.0	1,286	100.0
Liabilities								
Deposits and other demand liabilities	53	22.6	90	24.5	128	22.5	204	15.9
Debentures	103	43.8	188	51.1	341	59.8	851	66.2
Other Liabilities	10	4.3	9	2.4	11	1.9	56	4.4
Shareholders' Equity and reserves	69	29.4	81	22.0	90	15.8	175[c]	13.6

[a] Data for 1962 not entirely consistent with earlier years. A new D.B.S. survey raises the coverage. At the end of 1961, the new series gives total assets of $1,107 million compared to $1,022 million in the earlier series.

[b] Includes equities, investment in subsidiaries and foreign bonds as well as Canadian corporate bonds.

[c] This figure includes a small amount of net accruals and payables.

SOURCES: Dominion Bureau of Statistics and Bank of Canada.

obtains most of its funds from 15 and 20 year debentures. The companies usually have their debentures continually on sale "over the counter" but the one firm selling long-term issues does so by means of periodic underwritings. Although debentures are sold principally to individuals—some companies limit them to relatively small denominations—corporations and institutions take them as a convenient investment which is normally acceptable under trustee laws. Because they invest so heavily in mortgages and because the borrower has the right under the federal Interest Act to repay his loan at any time after five years, loan companies prefer to issue five-year debentures in order to avoid the possibility of paying high rates on longer-term debentures when mortgage rates have fallen. There is often a good deal of variety in the rates paid on debentures of different maturities, with the companies tending to make rates on maturities of five years and upwards attractive when they believe interest rates generally are at relatively low levels; conversely, some companies set such rates at relatively unattractive levels when they believe funds will shortly be available on better terms. However, not all firms believe in using their shorter-term liabilities as a balancing mechanism in this way, and some prefer to keep their emphasis on borrowing long (i.e. on five year terms or more) even at high rates if the demand for mortgages is strong.[11]

The important generalization which emerges from the evidence is that the crucial determinant of debenture rates is the yield available on conventional mortgages, the preferred investment of the companies. Representatives of the industry told us that it is common for management to have a view of the minimum acceptable spread between rates on mortgages and the price of new debenture money; in fact, this spread has narrowed only slightly in recent years and was almost 2½% in 1961. We were also told that each company is faced with a competitive mortgage rate, and cannot obtain business at a higher rate than other lenders are asking, while for the industry as a whole the demand for mortgage funds tends to dry up as rates rise above the levels to which borrowers are accustomed.[12] In these circumstances, the yield at which mortgages can be obtained and the desired yield spread set the effective limit on debenture rates, and the demand for mortgages is the principal influence on the growth of loan companies.

The bulk of loan company lending is on conventional residential mortgages, which under federal and Ontario legislation may not exceed two-thirds of the appraised value of the property. Most companies have not until recently invested much in N.H.A. mortgages because of their lower rate, their longer term, and what they consider to be their excessive administrative costs. There are exceptions, of which the most notable is a recently incorporated company dealing exclusively in N.H.A. mortgages and financing in a more flexible way than many of the other companies.[13] Moreover, when the yield differential between conventional and N.H.A. rates is low, as it was in 1961, the companies are prepared to invest more heavily in N.H.A.'s. The same is true when competition for conventional business becomes intense.

In addition to investing in mortgages, the loan and trust companies are permitted by Ontario to buy government securities of all kinds, mortgage securities, bonds, debentures, and preferred stocks of companies which have paid dividends for five years, and common stocks subject to a seven year dividend record equal to at least 4% of capital. They may not, however, hold more than 20% of the stock or other securities of a corporation and—except for federal, provincial and municipal obligations—may not have more than 15% of their capital and reserves invested in any one security or the securities of any one company. Certain individual investments in excess of these limits may be made if specifically authorized by the Ontario Government. Income-producing real estate is permitted up to 5% of total funds subject to a 1% limit on individual parcels. Loans, other than mortgage loans, may in general only be granted if the company takes as collateral

[11] Transcript, page 5878.

[12] Transcript pages 5859 and 5876-5886.

[13] See Submission of Canborough Corporation.

those securities in which it may invest and, in the case of corporate securities, if collateral exceeds the loan value by 20%. Finally, among these main investment provisions the Ontario Act now has a basket clause allowing the investment of 15% of capital and reserves in assets which are not otherwise eligible. Other acts are substantially the same, although the basket clause is peculiar to Ontario and in other ways the Ontario Act is generally the least restrictive.[14]

While detailed and restrictive in their intent, these provisions have not in fact put any meaningful restriction on the investment activities of the loan companies under post-war conditions.[15] In fact, their holdings of securities of all kinds—particularly federal obligations—while growing absolutely, have declined in relative importance as the strong post-war demand for mortgages has enabled the companies to invest a growing share of their funds in mortgage loans. Moreover, the powers of the Act have given the companies ample scope to experiment, as far as they have chosen to do so, with newer types of securities and investments. They do not trade their securities actively, although they are prepared to run down their holdings to obtain mortgages when credit restriction limits the availability of new funds.

The loan companies' cash ratios have also declined in the post-war period, partly as a result of more aggressive management and more plentiful investment opportunities, but partly also because the money market's development has enabled them to satisfy their relatively low liquidity requirements with short-term investments. Cash now runs at below 2% of total liabilities, compared to 4% or more earlier, while securities portfolios, which include securities which are not very liquid, now run below 20%. The companies can run with these low liquidity levels (backed up by bank lines of credit) because their main liabilities, debentures, are not redeemable before maturity, although on occasion the companies will pay them off on compassionate grounds. Some dealers also make a limited market in some debentures, but in general they are not regarded as liquid or marketable claims by either the companies or their holders. The companies' only short-term liabilities therefore, are their deposits, and their cash holdings are equivalent to about 8% of these liabilities.[16]

The business of mortgage loan companies has thus remained quite specialized and has not changed a great deal since the industry's early days with the exception that farm lending—which used to be a significant part of their activity—now accounts for under ½ of 1% of new mortgage loans. This is the result of unfavourable experience in the 1930's and, more importantly, of the fact that the companies can no longer compete with the low rates of government farm lending programs. While the loan companies have grown and prospered in the post-war period, they have not been as aggressive as some institutions in seeking funds to meet the strong demand for mortgage credit. Despite their rapid growth, therefore, they have not fully regained the place in the financial system which they held three decades ago.

2. *Trust Companies*

The trust companies, although similar in many ways to the loan companies, have in recent years been more willing to experiment and to develop important new types of business. They have thus enjoyed a more rapid growth than the loan companies in their intermediary business. They borrow somewhat more of their funds by way of deposits and correspondingly less by issuing guaranteed investment certificates, the practical equivalent of loan company debentures. On the other side of the balance sheet, mortgages are now the most important single type of investment, but their current level of 44% compares to over 76% of assets for the loan companies. Moreover, as we have already indicated, there is more diver-

[14] The foregoing is only a general summary of the legislation. Appendix 3 to the submission of the Dominion Mortgage and Investments Association gives a more detailed review of loan company legislation.

[15] Submission of the Dominion Mortgage and Investments Association, page 47.

[16] This calculation is based on the first three quarters of 1962: the December figure is omitted because of year-end window-dressing. See also Table 2 in Chapter 19.

TABLE 10–3

TRUST COMPANIES[a]
(December 31st)

	1945		1950		1955		1962[b]	
	$ mn	%	$ mn	%	$ mn	%	$ mn	%
Assets								
Cash	15	5.6	24	5.4	35	4.9	53	2.8
Securities:								
Govt. Canada	106	39.7	151	34.2	151	21.1	301	16.0
Provincial	14	5.2	41	9.3	90	12.6	136	7.2
Municipal	9	3.4	25	5.7	47	6.6	90	4.8
Corporate	28	10.5	51	11.6	103	14.4	337	18.0
Mortgages	61	22.9	114	25.9	228	31.9	831	44.3
Other Loans	18	6.7	18	4.1	36	5.0	82	4.4
Other Assets	16	6.0	17	3.9	25	3.5	46	2.5
TOTAL	266	100.0	441	100.0	714	100.0	1,877	100.0
Liabilities								
Deposits and other demand liabilities	83	31.2	166	37.6	275	38.5	656	34.9
Investment certificates	98	36.8	177	40.1	322	45.1	1,026	54.7
Other liabilities	17	6.4	13	2.9	15	2.1	10	0.5
Shareholders' equity and reserves	68	25.6	85	19.3	102	14.3	185[c]	9.9

[a]In this table and in our discussion of trust companies we do not distinguish between the "company" and "guaranteed" accounts as it would complicate the presentation unnecessarily.

[b]The new comprehensive DBS series used is not entirely consistent with the earlier Bank of Canada data, but differs from it little in total.

[c]This figure includes a small amount of net accruals and payables.

SOURCES: Dominion Bureau of Statistics and Bank of Canada.

sity among trust than among loan companies, with mortgage investment accounting for as little as 10 to 15% of assets in some cases—including one large company—and as much as 76% in another. There is a correspondingly wide variation in other assets, which in some cases may be quite long-term bond holdings and in others may include substantial money market investments.

Trust companies offer both chequable and non-chequable demand accounts as well as term deposits and investment certificates: the demand liabilities in total represent just over a third of funds employed, more than double the figure for loan companies.[17] Subject to the qualifications noted in the preceding footnote, it appears that about two-thirds of all trust company demand liabilities are chequable deposits. Their deposit facilities have attracted the savings of individuals rather than corporate funds and the companies have made particular efforts to tailor this side of their business to the convenience of families and individuals. A classification of the accounts in a sample of trust and loan companies in October 1961 shows that 85% of the funds in chequing accounts and 73% in other demand accounts were owned by individuals.[18] In order to cultivate this market, many companies have expanded their branch systems in the suburban areas where family savings are higher than average, (the average deposit, for example, appears to be three times the size of those in caisses populaires), have adopted a variety of branch hours

[17] The figures are somewhat difficult to unravel since many term deposit accounts are classified by certain companies as guaranteed investment certificates; conversely, some companies classify as certificates what would more generally be regarded as deposits. The D.B.S., now publishing quarterly data on the companies, is taking steps to introduce a uniform classification.

[18] *The Role of Trust and Loan Companies in the Canadian Economy*, prepared at the University of Western Ontario, Table 11-19, reproduced in the appendix volume to this report.

to appeal to customers, and have tried to attract business by offering gifts and bonuses to new customers. In 1961, 44 of the 217 offices of members of the Trust Companies Association of Canada were savings offices of this type which did not offer the full range of trust company services.

Although many of their accounts offer chequing privileges and these deposits turn over three to four times a year—more than twice the rate of bank savings accounts—the companies are not anxious to have them used as current accounts. They discourage active use by means of service charges, which vary from company to company, and may on occasion even suggest that a customer use a chartered bank account for his regular payments.[19] Nonetheless, some of the companies have made very flexible use of free chequing privileges to attract business, although because they are precluded from making commercial loans this feature has not attracted many corporate current accounts from the banks. We were also told that some companies have stressed their non-chequable deposit business because they do not like to rely too heavily on chequable accounts for which they must apply to the chartered banks for clearing arrangements. It must be stressed that this is mainly a reflection of vague fears about the future and not of difficulty experienced to date.

Guaranteed investment certificates (GIC's) are also sold to individuals, but this type of trust company liability, unlike the deposit accounts, attracts a substantial amount of corporate funds. According to the survey already mentioned, about one-half of the funds invested in certificates, debentures and term deposits of trust and loan companies come from individuals and about 40% from business corporations. Although loan company instruments are included in this classification, most of the corporate funds were in trust company certificates and the sample shows that virtually all were in amounts over $5,000.[20] Certificates are made available in standard maturities of one year, two years and so on, but some companies will issue them in any maturity to suit the investor.

The trust companies borrow very little in over five-year maturities, unlike some loan companies, appearing to be even more worried by the possibility that the rates on their mortgage investments may be adjusted after five years. However, some companies, particularly the larger ones, have developed a large market for certificates of one year or less in competition with other short-term investments such as commercial paper, chartered bank deposit receipts and treasury bills: indeed, they were among the early borrowers in this market, having sold short GIC's before a money market developed in Canada.[21] This source of funds has accounted for a good part—perhaps as much as a third—of the recent rapid growth of some trust companies and has been a major factor leading them to expand more rapidly than the loan companies. Data on 17 trust companies at the end of 1962 shows that no less than 26% of outstanding GIC's were due to mature in under six months, a further 17% in under one year, and 14% more came due within two years. On the other hand, only 2% had a maturity of five years and over. It should be noted that these figures include what are in essence the time deposits of two Quebec companies, one of which did not then formally accept deposits at all. While the maturity of these GIC's when originally issued would be somewhat longer than the above data suggest, it is nevertheless true that some companies are very active issuers of short-term liabilities.

Corporate and other investors have been attracted by the convenience of GIC's and by the willingness of some of the companies to design them to individual requirements for size and term. Moreover, they are easily available, either directly or, in some cases, through investment dealers. These factors, and the safe nature of the certificates have, however, been less important than attractive interest rates in influencing the flow of funds into these liabilities: these rates have provided more than sufficient appeal to overcome the

[19] Submission, para. 3.34 and Transcript, page 3427.

[20] *Op. cit.* Table 11-20, reproduced in the appendix volume to this report.

[21] Submission para. 3.31.

disadvantage of lack of marketability, although some companies will redeem them in unusual circumstances.

We have already indicated the main lines of trust company investment policies and the legislation which governs them. The only major difference between their intermediary lending powers and those of loan companies in Ontario is that 50% of "guaranteed" funds must be kept in the narrower group of assets permitted by the Trustee Act: the remainder may be invested in the same way as company funds.[22] Like the loan companies, the trust companies had not been active N.H.A. mortgage lenders, preferring to stress conventional residential lending which is more closely related to the trustee and estates business and in which competition has been less intense than in the industrial mortgage field. However, stronger competition for conventional residential mortgages—in amount and term of loans as well as rates—has brought about a change in some companies' policies: the industry accounted for no less than one-third of institutional approvals of N.H.A. mortgages in 1960-62. Thus when N.H.A. mortgage rates and terms have moved closer to those on conventional mortgages, the companies have overcome their aversion to the longer term, lower rate, and increased paper-work of N.H.A. lending.

While all mortgages have grown in importance for the industry as a whole despite the virtual cessation of farm lending, many companies have a preference for longer-term corporate bonds when these are available: provincial and municipal obligations retain a relatively modest place in the portfolio of most companies. Government of Canada securities have been run down relatively to finance acquisition of mortgages and corporate securities, while equities have remained a small proportion of total investments. Total equity holdings, excluding investment in subsidiary or associated companies, were only $63 million at book value in December 1962. They represented just over 3% of trust company assets, a slightly higher share than for the loan companies.

The companies which have developed the short-term business are the most diversified, for they are in most cases important mortgage lenders as well. These companies invest in a broad range of short-term assets and have played a part in the development of the money market. They are permitted to make secured loans and as "country bankers" often supply a substantial part of the investment dealers' requirements for inventory finance. While not active in the treasury bill or pure day-loan market because of the low yields involved, they accept short-term investments in guaranteed investment certificates and term deposits for customers who are not permitted or not willing to make direct purchases of commercial paper or other instruments on which the yield may be somewhat higher. These transactions are often done through the dealers who, as part of the transaction, may also arrange an "offset" purchase of the higher-yielding investment for the trust company. In this and other ways the trust companies, particularly those in Toronto, work closely with dealers in their short-term business; the Montreal companies tend to arrange more of these transactions directly with customers.

Whether or not they are active in the money market, trust companies need to carry part of their assets in cash and other liquid forms to meet the ordinary needs of their business. The industry's average holdings of Canadian cash now normally run between 1½% and 3% of all assets, averaging 1.7% in 1962. The ratio has come down from somewhat higher levels as the companies have covered their short-run liquidity needs by carrying money-market assets. If these cash holdings are related only to demand liabilities, chequable and non-chequable, their cash ratio in 1962 was approximately 5%.[23] As noted earlier, the 20% liquidity requirement applying to the companies is virtually meaningless and they have no difficulty in meeting it, even though many of their government securities are not in fact very liquid. Securities outside the money market range

[22] Like the loan companies, they are permitted by Ontario law to lend against, but not invest in, GIC's although this is rarely done. Federal legislation allows funds to be invested in GIC's if they are a trustee investment in the province concerned.

[23] See Table 2 in Chapter 19.

are not very actively traded, although some companies are more market-conscious than others; securities in the companies' own accounts are rarely turned over because of concern that capital gains might not remain tax-exempt in these accounts if a policy of trading were adopted.[24]

Despite their rapid growth in the post-war period and despite the fact that bonds accounted for 35% of trust companies' assets at the end of 1962, they are by no means a major factor in the bond markets. The portfolios of the trust and loan companies combined accounted for only 2.7% of outstanding federal marketable securities at the end of 1962, and about the same share of provincial, municipal and corporate securities. In the mortgage market, however, they held no less than 23% of all mortgages held by institutions and 35% of conventional mortgages. While the role of the trust companies in the financial system is growing in importance due to the flexibility of their operations and to their willingness to innovate, it is well to remember that as intermediaries they are still only one-eighth the size of the banks and about a fifth the size of the life insurance companies.

TRUST AND LOAN COMPANIES IN CHANGING CREDIT CONDITIONS

The main factor influencing the flow of funds to trust and loan companies has been the rate of interest paid on their deposits, certificates and debentures. It appears from the record that the growth rates of their liabilities are decisively affected by the level of their rates relative to those on competing savings instruments, and that the companies have been affected by changes in monetary policy through its influence on their ability to pay rates sufficiently high to attract funds.

The rates on trust and loan company chequable deposits rose gradually during the 1950's in step with the general increase in rate levels but have not been sensitive to the short-run cycles in credit conditions. We were told that the companies adjust their rates only after the general level of rates has shifted and a new level appears to have been established.[25] The deposit rates have, in fact, been almost as inflexible as those on chartered bank savings deposits but about ½ of 1% higher, as shown in Chart 10-1. Rates on certificates and debentures have been more responsive to changes in the financial climate, rising rapidly in 1956-57, in 1959 (after being cut back in the easier conditions of 1958), and again in 1962. It will be noted in chart 10-2 that the differential between the average rate paid on five year debentures and certificates and the conventional mortgage rate, which widens in periods of easy money, narrows with tightening credit conditions as the companies' borrowing rate moves up closer to the less flexible rate on this important earning asset.

At the same time, the companies feel increasing competition for short-term funds because of the high yields available on such alternative investments as treasury bills, short bonds, and finance company and commercial paper. Thus their ability to attract funds is limited in periods of tight money by the effects of competition on the margin between the yields on their assets and liabilities. The result of these changes in the market has been that trust and loan companies have grown rapidly in periods when money was not tight but that their expansion has been curtailed when the Bank of Canada has adopted a restrictive policy which no longer enables them to pay rates which attract business from their competitors.[26]

The impact of tight money has been more pronounced on the trust than on the loan companies. While the trust companies continued to grow, their rate of expansion fell dramatically in 1956-57 and again in 1959. (The fall was less sharp in 1962 in view of the fact that monetary restriction was short-lived in that year and had given way to easier conditions again in the autumn). This relatively heavy impact results partly from the fact that deposits, which are a relatively important source of funds and on which the in-

[24] Transcript, pp. 3589-90.

[25] See comments by spokesmen for the industry, Transcript pp. 3426 ff.

[26] See Charts 2 and 3 in Chapter 11.

TRUST AND LOAN COMPANIES INTEREST RATES

Chart 10-1
Monthly

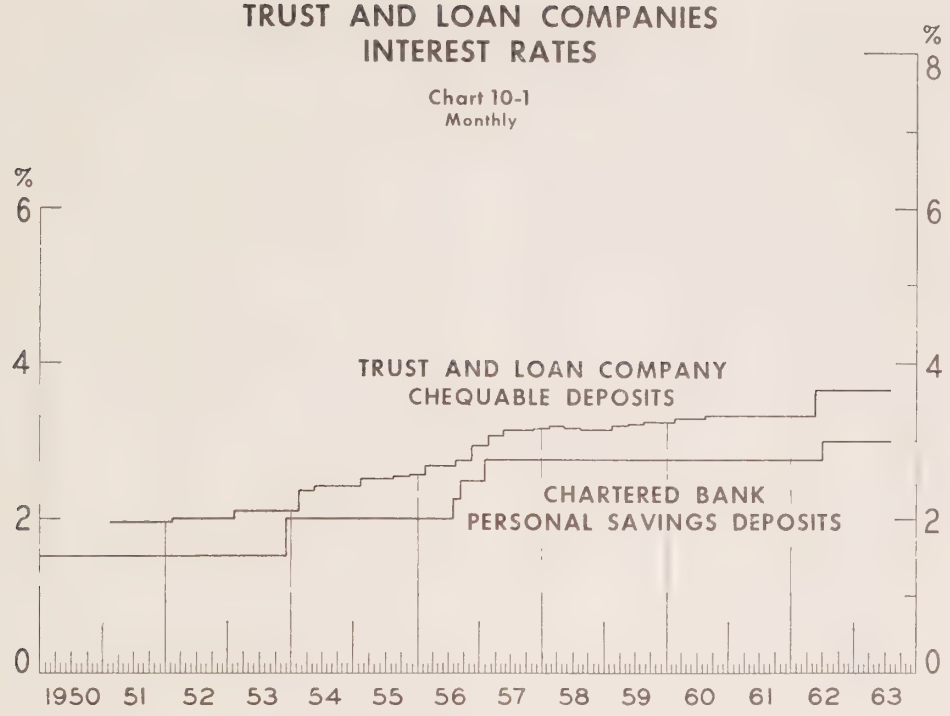
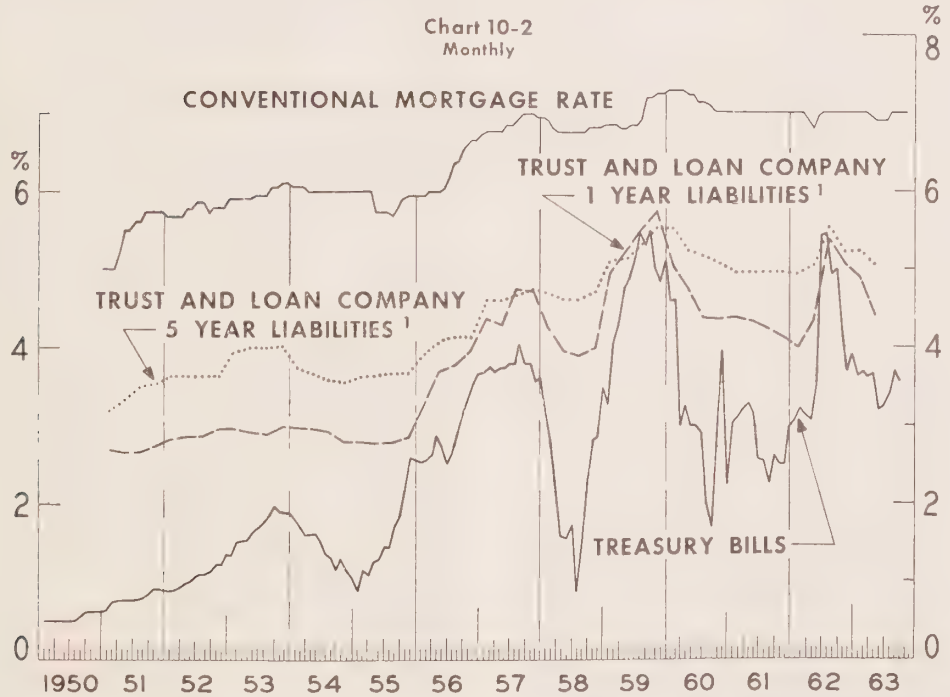


Chart 10-2
Monthly



1. Average rates paid on certificates or debentures with original terms of 5 years and 1 year.

terest rate is quite inflexible, are affected more severely than longer-term GIC's or debentures: this can be seen in the previous table. In addition, the rates on the trust companies' shorter-term GIC's, while flexible, rise less than those on many competing instruments. Thus, the very success which the trust companies have achieved as borrowers in the sophisticated and rate-conscious short-term market when rates are not at peak levels exposes them more quickly and completely to the volatility of short-term interest rates and to sharp changes in the flow of highly-liquid funds when the companies are unable or unwilling to raise their rates as high as other market rates. Loan companies are less dependent on deposits, and the industry as a whole succeeded in stepping up the growth rate of debentures in 1959 and again, but less noticeably, in 1962 by being prepared to pay the necessary rates.

ANNUAL PERCENTAGE RATES OF CHANGE

—	Trust Companies			Loan Companies		
	Total Liab.	Deposits and other Demand Liabs.	Guaranteed Certificates	Total Liab.	Deposits and other Demand Liabs.	Debentures
	%	%	%	%	%	%
1951	3.2	2.4	4.0	5.4	−2.2	13.8
1952	4.6	6.5	4.7	6.7	4.5	9.3
1953	1.7	3.3	−0.5	7.7	2.2	12.0
1954	30.8	32.6	44.2	15.1	17.0	17.2
1955	12.8	10.9	16.2	11.3	16.4	11.1
1956	3.8	6.2	1.0	7.2	−4.7	10.9
1957	5.3	−1.0	10.8	6.9	−0.8	10.3
1958	22.8	24.9	28.9	11.3	15.7	10.8
1959	10.8	−3.3	22.8	9.9	−9.3	18.0
1960	21.0	23.5	23.0	10.3	12.6	11.4
1961	23.8	26.0	23.4	17.1	31.9	14.4
1962	18.3	17.6	21.0	16.2	14.6	15.0

Apart from this difference in the size of the adjustment they are required to make in periods of credit restraint, the investment policies of loan and trust companies respond in essentially the same way. The accompanying charts, based on seasonally adjusted series covering companies having about 50% of the assets of all loan companies and almost 70% of trust company assets, show that when the funds available to them fail to grow or decline they continue to build their mortgage portfolios. Indeed, the rate of increase was stepped up in 1956 and again in 1959, for these were times when mortgage demand was strong. In order to obtain funds they run off their holdings of bonds, particularly Government of Canada and provincial issues. There is some tendency for the companies to run down their cash ratios as part of the adjustment process, but this contributes less to continued mortgage investment than does the selling of bonds. Finally, some rationing of credit is resorted to, particularly by those companies which are reluctant to issue longer-term debentures in periods of relatively high interest rates. The conclusion is inescapable that the trust and loan companies feel the impact of changing credit conditions clearly and must alter their operations accordingly, although the demands on them are not as insistent as those of chartered bank borrowers and they have not had to cut back on lending as severely as the banks in periods of extreme restriction.

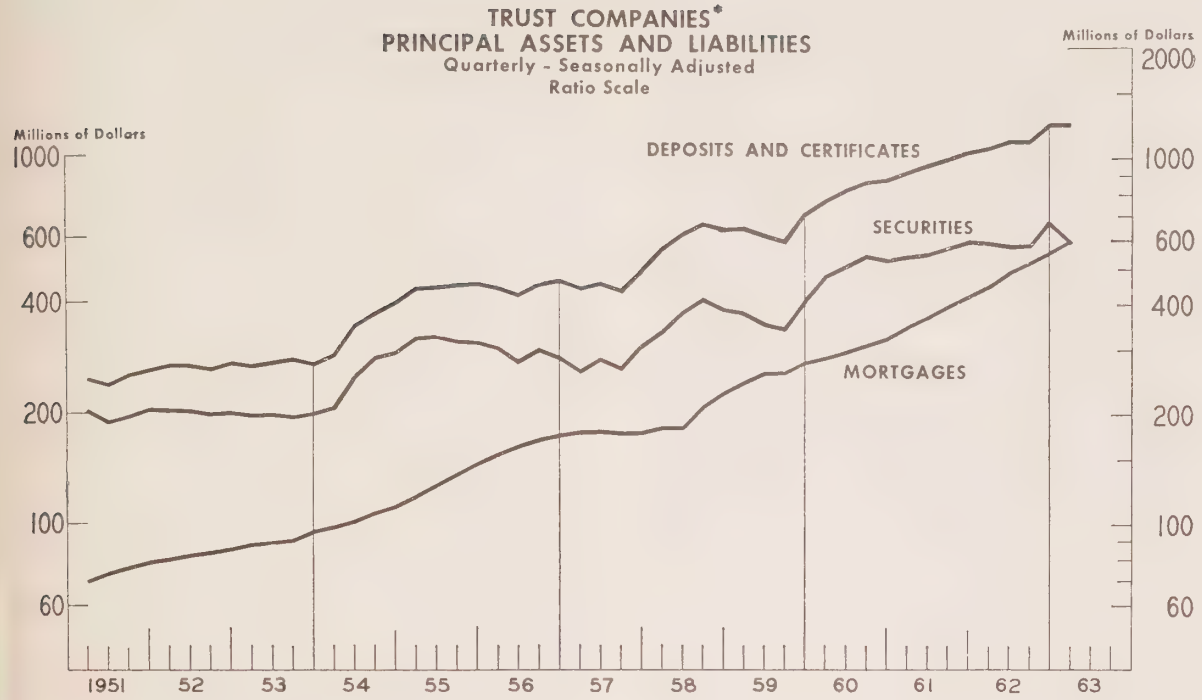
TRUST COMPANY FIDUCIARY BUSINESS

The estate, trust and agency activities of the trust companies are quite different from the intermediary business we have been discussing. In the latter, funds gathered from many sources become a single pool available for investment in the company's portfolio of assets and the company retains any difference between revenues and administrative and borrowing expenses. On the other hand, estate and trust business—and much of the agency work—consists of managing individual asset holdings to maximize the objectives of the beneficiaries in return for a percentage or fixed fee. Provincial trustee laws, which govern estates and trusts, call for each account to be kept and managed separately, as do the agreements setting up agencies. This is true even though the account may itself be a large accumulation of funds drawn from many

Chart 10-3

TRUST COMPANIES* PRINCIPAL ASSETS AND LIABILITIES

Quarterly - Seasonally Adjusted
Ratio Scale

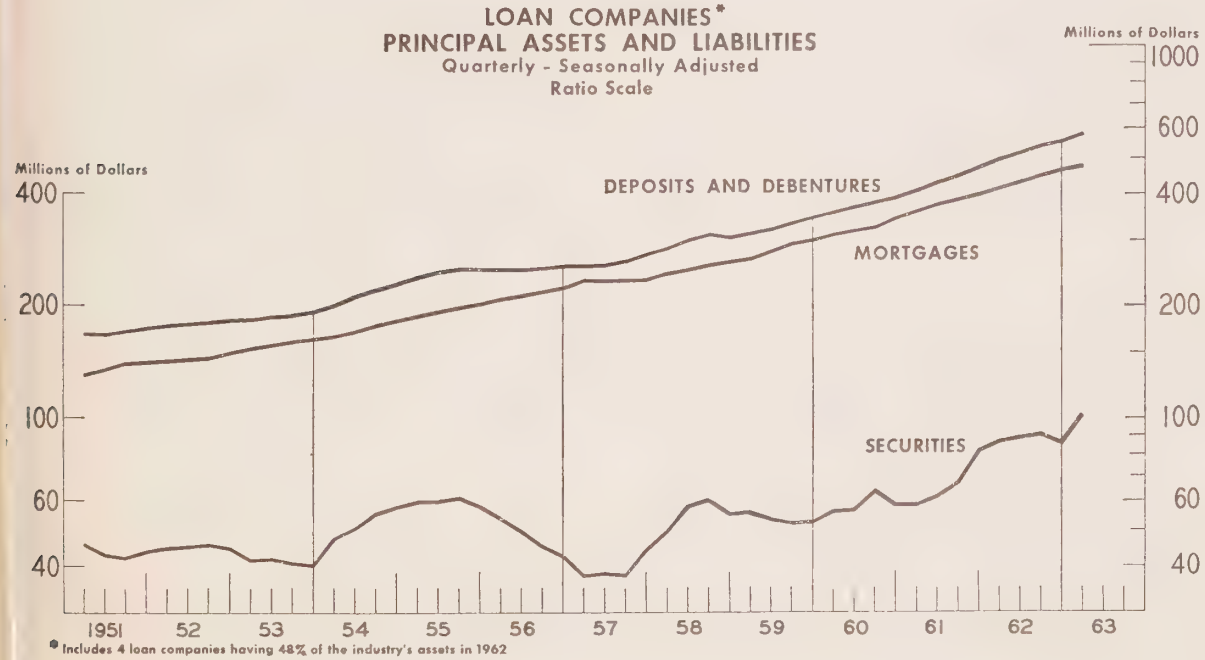


*Includes 11 trust companies having 69% of the industry's assets in 1962

Chart 10-4

LOAN COMPANIES* PRINCIPAL ASSETS AND LIABILITIES

Quarterly - Seasonally Adjusted
Ratio Scale



* Includes 4 loan companies having 48% of the industry's assets in 1962

75319—13½

sources, as is the case with pension trusts. In effect, instead of managing his affairs privately or with the help of individual lawyers and investment advisors, the beneficiary or original owner of the property has chosen to buy the services and skills of a trust company to manage them for him. Thus these funds are more akin to the directly held financial assets of individuals and corporations than to their holdings of institutional liabilities, even though both share the benefit of professional investment management.[27]

Trust companies are not the only trustees: they compete for the business with individuals, particularly lawyers and notaries, who act as trustees and administrators for funds which, while not covered by available statistics, must be very large in aggregate. In Quebec, where trustee law differs from the common law provinces, individuals do a larger share of the business than in other provinces.[28] Provincial governments have also established trustee departments under various names to act for wards of the state, such as the mentally ill, and in general to provide trustee facilities for those unable to obtain them elsewhere. Given these facilities and those of the trust companies, we have not found strong evidence of a shortage of trust facilities in Canada. It is noteworthy, however, that the companies have less than 200 offices offering full trust services and that more than half of these are in Ontario. In the United States, where many banks are also trustees, facilities are more generally available.

Material on the size and composition of E.T. & A. funds in Canada has been sketchy since each company reports only the aggregate book value of the assets it administers and there are no standard valuation rules on which this reporting is based. Because most companies carry assets at their original cost, and in some cases use nominal values, the book valuation is often well below current market values. Even at book values the amount involved is very large and has been growing at an accelerating rate:

	Total E.T. & A. Assets ($ millions)	Average annual rate of increase—%
1945	3,035	
1950	3,614	3.5
1955	4,713	5.4
1960	7,375	9.4
1961	8,270	12.1

SOURCE: *Bank of Canada Statistical Summaries*—includes pension funds under administration.

The principal factors leading to the expansion of E.T. & A. funds are the general increase in the wealth of the community, the attraction of new customers by direct solicitation, advertising and the expansion of trust company branch systems, the reputation of the companies for careful investment management, and an increasing awareness of the succession duty and estate tax savings which can result from trust company advice and management.

The spread of pension plans, many of which are trusteed with the companies, has also swelled the total of funds under administration. We estimate that the companies now administer something between 15% and 20% of the primary debt not held by financial institutions and a somewhat smaller proportion of Canadian equities. Data are not available to compare this with earlier periods, but rough calculations do not indicate that the recent tendency for a slightly larger share of such debt and equity holdings to gravitate to trust company administration has greatly altered this proportion since the end of the war.[29]

Largely because maximum fees for estate and trust work are set by the courts, the companies

[27] For this reason E.T. & A. funds were not included in the institutional sector in Table 6-1.

[28] Transcript, page 3349.

[29] In the first post-war decade, there appears to have been some tendency for the assets under trust company administration to decline relative to the total.

tend to adopt common fee schedules. However, there is some competition for business on a price basis, but it is not nearly as pronounced as in their pension fund business where price is an important part of the competition for accounts. As mentioned earlier, E.T. & A. business is more concentrated in the hands of a few companies than is the intermediary business. This is because established companies with skilled staffs, particularly those with bank connections, enjoy advantages in attracting large accounts, and because other companies, finding it more profitable and easier to engage in the intermediary business, have often preferred to concentrate on developing that side of their activities.

Three companies having about 60% of the assets under administration have greatly improved our knowledge of the E.T. & A. business by conducting a sample survey for us in four large Montreal and Toronto offices. The survey, conducted in mid-1962, was carefully designed to be representative of the business done in these offices, but unfortunately we have no way of telling how representative it is of the industry as a whole. It may well be that the inclusion only of metropolitan offices of large companies biases the results, for instance by exaggerating the importance of agency accounts and by including too high a proportion of large accounts. Nonetheless, this sample is all we have to go by and we have drawn on the results for the following discussion.

The survey did not cover pension funds or deposit securities held for insurance companies as both of these rather special fields are covered in other statistics. The book value of other accounts administered by all companies was $6.5 billion at the end of 1961 and the sample survey included accounts holding about one-eigth of these funds. On the basis of the relationship between book and market values for the three companies in the sample, and of descriptions of the valuation procedures followed by other companies, we estimate that the market value of the reported $6.5 billion of assets was about $8.7 billion. Adding back the pension funds under administration (reported by the companies at a realistic valuation of about $1.4 billion) and the market value of insurance company deposit securities as published by the Superintendent of Insurance ($1.8 billion compared to the much more nominal values placed on them by the trust companies) we arrive at a total of $11.9 billion for all E.T. & A. funds compared to the published book value of $8.3 billion at the end of 1961.[30]

The following table shows the distribution of the 798 accounts in the sample, which included all of the accounts of $10 million or more in the offices concerned and declining proportions of accounts in smaller size classes. The results were reweighted to bring them into line with the average size structure of all accounts and the following discussion is based on the resulting estimates.

[30] Since we have not attempted to place a market value on real estate holdings, which accounted for about ½ of 1% of the book value of the sample, there is still some understatement in this rough estimate of market values. A full description of the survey is given in the appendix volume.

TABLE 10–4

DISTRIBUTION OF ACCOUNTS IN THE SURVEY

	Number of Accounts		Assets Held in the Accounts			
			Book Value		Market Value	
		%	$ mn	%	$ mn	%
Estates	404	51	238.0	28	340.9	28
Living trusts of persons	97	12	53.8	6	86.9	7
Living trusts of institutions	22	3	89.6	11	110.9	9
Agencies	275	34	456.1	55	674.4	56
TOTAL	798	100	832.5	100	1,231.1	100

Almost one-half the funds (44%) were held by trust companies under agency agreements in which the company simply takes custody of the assets and carries out the instructions of the owner for their administration. The owner may choose a particular company partly for its investment skills and because he expects to receive good advice, but the company is not trustee for the assets and is not responsible for managing them beyond routine duties such as collection of dividends and interest. In addition to holding financial assets under agencies, trust companies offer a great many other services of a rather similar character. Perhaps the most important of these is property management, in which they have acquired special skills through their own mortgage business and through the management of real estate which they administer as executor under wills. Other agency services provided by them include the administration of custody and escrow arrangements and acting as receivers.

A high proportion of assets in agency and institutional trust accounts is held in relatively few large accounts. As the following table shows, about 30% of such funds are in accounts of $10 million or more, compared to 4% of estate account funds and 8% in other personal trusts.

The remaining 56% of funds administered by trust companies were held in estates and trusts set up under wills or in "living trusts" in which a trust agreement other than a will appoints them to hold and administer assets for individuals or other beneficiaries such as universities and charitable foundations. The trust, unlike an agency agreement, vests the legal ownership of the assets with the trustee but sets out the beneficiaries' rights and the limits on the trustee's freedom of action. Under some trusts the company may have little or no independence to manage the assets because the agreement names other trustees who make the investment decisions. According to our survey, this type of trust is unusual except in the case of institutional trusts, which are mainly of this character. Trusts arising out of wills may appoint co-trustees to act with the trust company but nearly always give the company a share in the management decisions. In the survey, 30% of estate assets were in accounts for which the trust company was sole trustee, and most of the remainder in accounts with co-trustees, with a small share in accounts for which the company had no trustee responsibility. Different views were expressed at our hearings on the desirability of having co-trustees: some companies seem anxious to have the views of family or friends while others prefer the freedom of sole trusteeship and do not relish sharing the fees with co-trustees.[31]

[31] Transcript, pages 3307-3311.

TABLE 10–5

ESTIMATED SIZE DISTRIBUTION OF ACCOUNTS[a]

	Estates and Testamentary Trusts		Living Trusts				Agency Accounts	
			Personal		Institutional			
	no. of accounts	assets	no. of accounts	assets	no. of accounts	assets	no. of accounts	assets
Accounts of:								
less than $100,000	71%	14%	74%	14%	51%	3%	62%	6%
$100,000 to $1 mn.	27	58	24	53	30	12	32	32
$1 mn. to $10 mn.	2	24	2	25	17	55	6	31
$10 mn. and over	[b]	4	[b]	8	2	30	[b]	31
TOTAL	100	100	100	100	100	100	100	100

[a] This table, like the others in this section, is based on the market value of assets. Since it was not possible to place market values on real estate holdings, which account for .6% of the book value of funds, they are excluded from all classifications shown.

[b] Less than ½%.

While some trust instruments place no restriction on the way funds may be invested, others do establish specific limitations and thus serve to limit the trust companies' freedom. Many trusts are limited to assets eligible under the provincial trustee laws, and where the will or other instrument says nothing on the subject the trustee laws automatically prevail.[32] The trust companies prefer the instrument to leave them free of investment restrictions and told us that there is a definite trend towards the inclusion of unrestricted investment powers in wills and other trust instruments. Although we classified the survey according to the date at which accounts were established, the sample was unfortunately not large enough to confirm any trend to broader powers: it did show, however, that about three-quarters of the assets administered under wills were in unrestricted accounts, although views expressed at our hearings suggest that this may be too high a proportion for the industry as a whole.[33] Since smaller estates are more frequently subject to limitations than large ones, the proportion of unrestricted accounts was somewhat lower.

The trust companies feel that greater uniformity in trustee laws would improve efficiency and investment results, and also recommend that the legislation should permit investment of 35% of the funds in a trust in corporate stocks and bonds subject to quality tests.[34] Nova Scotia now permits 15% and we see no harm in the general adoption of more liberal trustee laws, particularly for professional trustees; however, it should be remembered that the laws are intended to protect the unwary and do not stand in the way of anyone wishing to place no restriction at all on his estate or trust.

Contrary to popular assumption, our survey showed that well over one-half of the funds in estates, trusts and agency accounts are invested in Canadian and foreign equities. A few large agency accounts are invested particularly in foreign equities. Smaller estates and those subject

[32] See page 48 of the trust companies' submission for lists of assets eligible under trustee laws. In general they include federal and provincial securities, municipal issues (sometimes only those in the same province), mortgage bonds and debentures, first mortgages on real estate, and trust and loan company liabilities. Corporate stocks and bonds are generally not eligible although Nova Scotia and British Columbia have liberalized their laws, while U.S. and U.K. government securities are permitted by some provinces.

[33] Transcript, pages 3319-3321 and trust companies' submission para. 2.25 and following.

[34] Trust companies' submission para. 2.32 and Transcript page 3343.

TABLE 10–6

ESTIMATED DISTRIBUTION OF ASSETS, MARKET VALUES

	Estates	Personal Trusts	Institutional Trusts	Agency Accounts	Total
	%	%	%	%	%
Govt. of Canada securities	11	8	10	12	11
Provincial securities	13	10	12	7	10
Municipal securities	3	2	5	2	3
Corporate bonds and debentures[a]	8	10	21	12	11
Canadian equities	55	51	33	43	48
Foreign securities					
bonds	1	2	2	1	1
equities	4	13	16	18	12
Mortgages	3	1	[b]	1	1
Cash and other assets	2	3	1	4	3
Total excluding real estate	100	100	100	100	100

[a] Including short-term paper and trust company certificates.

[b] Less than ½%.

to investment restrictions tend to have higher bond and lower stock holdings but even in these the share of equities runs from 25% to 40%. (Restrictions such as those in trustee laws apply to new acquisitions only: equities included in the original assets taken under administration may frequently be kept.) The share of funds invested in mortgages in the sample accounts is much lower than the 7% or so reported for 14 companies in the University of Western Ontario study. We have no explanation for the difference.

Quite apart from the views of other trustees or any investment restrictions, the amount of trading and portfolio adjustment possible in an account is often severely limited by real conflicts in the interests of different beneficiaries. If one person receives the income from a trust during his lifetime (the "life tenant") while a "remainderman" subsequently inherits the principal, it is, in many cases, difficult to trade for the advantage of one without damaging the equal interests of the other. Moreover, it is a principle of trustee law, reinforced in the companies' minds by the experience of the 1930's, that capital must be preserved intact unless the trust instrument specifies otherwise; the trustee must be prepared to justify any impairment of capital to the courts in their periodic examinations of the account. For these reasons the companies do not trade most of their accounts actively, unless—as quite frequently happens—they have the voluntary consent of both interests. Instead, they concentrate their investment decisions on choices about the investment of new money and the reinvestment of maturing issues.[35] Investments are carefully considered by the officers responsible for each account and committees of senior management, and while quick action is always possible in unusual circumstances, there is not generally a sense of urgency or haste about buying and selling.[36]

It is therefore not surprising that the detailed reports of market purchases and sales in the sample during the six months prior to the survey date show that most accounts are not actively traded. Purchases and sales each averaged about 5% of assets in estates and in personal trusts[37] and considerably less in institutional trusts. Agency accounts, unaffected by the considerations mentioned above, are traded more actively, with purchases and sales averaging about 10% of assets during the six month period.[38] While there is a definite tendency for larger accounts and those having no investment restrictions to be traded more actively, the survey results do not show more active switching by trust companies in accounts which they alone administer compared to accounts in which others are involved in trading decisions. In each of the main types of account the survey shows considerably less trading of Government of Canada securities relative to the amounts held than was reported to us for the secondary market as a whole by the Investment Dealers' Association.[39] Other bonds also appear to be traded somewhat less actively in estate and trust accounts than by other holders, although this is not true of agency accounts which, according to the survey, were relatively active traders in the period concerned.

In view of the number and variety of accounts which they administer and the fact that each one is a separate entity with individual investment objectives, we cannot form any meaningful view of the investment skills of trust companies as trust administrators. It would certainly be wrong to take aggregate figures as an indication of the way in which individual accounts are or should be managed. The companies appear to manage their accounts carefully and conservatively: their view, with which we do not quarrel, is that the person setting up a trust can always take steps to see that more adventuresome policies are followed and, failing this sort of specific intent, a conscientious trustee must always be prudent in his administration. The companies are not, however, excessively conservative for the survey shows

[35] Transcript, pages 3322, 3331.

[36] Transcript, page 3317.

[37] Excluding one large and unusually actively traded personal trust. If this account is included, purchases and sales averaged 10% of personal trust assets.

[38] Transcript, page 3342.

[39] Submission of the I.D.A., Appendix F, page 4 and Chapter 16 of this report.

them investing large sums in equities: moreover, they are anxious to see broader trustee legislation adopted so that more common stocks can be placed in client accounts.

Some provincial laws allow a trust company to invest trust money in common funds, which are in effect mutual funds operated for the benefit of their administered accounts. These funds, which in some cases have separate mortgage, bond, and equity units, are intended to bring greater efficiency to the management of small estates. Although a few companies have successfully opened them up to public subscription, they have not grown as much as was hoped because changes in the per-share value of the fund raise conflicts between the life-tenant and the remainderman in the sharing of income and changes in capital values.[40]

In addition to taking custody of assets and administering them under trust and agency agreements, the trust companies do "corporate trustee" work which does not involve the management of assets. They are appointed as trustees for bond and debenture issues to hold the collateral and see that the borrower meets his obligations, as registry and transfer agents for equity issues, and to carry out a variety of other functions relating to the new issue market.[41] The companies able to attract such accounts, mainly larger companies which have chartered bank associations, find this the most profitable part of E.T. & A. business. The trust deeds set out the duties of the trustee but also carefully define the limits of his responsibility in order to protect the trustee from having to meet the obligations of a defaulting borrower regardless of his power to have prevented the trouble or forewarned the bondholders. While it is bound to be difficult to judge how far a corporate trustee can or should go, we have heard it argued that Canadian trust companies are perhaps over-careful about protecting themselves rather than guarding the interests of the security holders for whom they are trustees. In the United States an enquiry by the S.E.C. led to the passage of the Trust Indenture Act which sets out the duties of bond trustees. There is no similar law in Canada so that the duties vary from trust deed to trust deed, and the care with which they are executed may vary from company to company. While we have not heard of specific abuses, it is most desirable that the companies and the authorities ensure that trustees are in no sense lax. In this connection, we welcome the efforts of the Trust Companies' Association to improve the performance of the industry.

The trust companies inevitably encounter conflicts of interest in the course of their work. Some are conflicts between two accounts which they administer and can only be resolved by managing each account separately in its own best interests. In others, the companies' own investments in company and guaranteeed accounts or its interests as a corporate trustee may be involved, and again the company must scrupulously follow the best interests of its E.T. & A. customers and consider its own position second. For instance, it is clearly inadmissible for a company to buy bonds for estates or trusts simply in order to induce the issuer to give it the trustee and registrar business or to buy or sell securities for E.T. & A. customers other than through impersonal markets. It is difficult to see how such abuses are to be prevented absolutely because any trustee is in a position to use the funds he administers to his own advantage if he wishes. Examination by the courts and supervisory authorities is essential, but the strongest protection must be in the conscience of the trustee himself and his desire to preserve the reputation on which his business depends. We believe that the Canadian companies set themselves high standards. We therefore would not recommend that the trust and intermediary business be divorced, especially since such a step would probably reduce the availability and standards of trustee services to the public by leading many companies to devote their skills and experience to the more profitable intermediary business.

[40] See Trust Companies Submission para. 2.37 and Transcript, page 3351.

[41] See Trust Companies Submission, Section 4 and Winslow Benson, *Business Methods of Canadian Trust Companies*, Ryerson Press, 1962, pages 141-210.

Concern has been expressed at the concentration of equity holdings in the trust companies' own portfolios and in administered accounts. As already indicated, these appear to represent well under 20% of all Canadian common stocks and are spread between a fairly sizable number of companies, many of whose E.T. & A. clients vote their shares independently. Moreover, the trust companies' normal policy is to support existing management except in very unusual circumstances or unless they have very large stock holdings in one or a number of accounts, in which case they normally have an officer on the board to keep a watching brief in the interests of their clients.[42] Where conflicts arise, as between common and preferred shareholders, they must vote each account in its own interests, and have told us that they do so.[43] This essentially passive role as shareholders does not mean that they take no interest in how competently the companies in which they or their clients have invested are being managed. In fact, many trust companies follow the corporate affairs of such enterprises very closely, and if they do not like developments they sell out or take steps to intervene. As long as this continues to be the practice, we see no danger of shareholder control being abdicated. Nor do we foresee any possibility in the near future that trust company influence on corporate life will become so pervasive as to constitute a danger to the interests of the public.

RELATIONSHIPS BETWEEN BANKS AND TRUST COMPANIES

In any financial community close relationships are bound to develop among the participants since practically all institutions need the services of others in the course of their daily activities. It is not surprising that in the network of relationships among institutions and dealers some are closer than others; those involved are bound to find themselves working most closely and continuously with people whom they find congenial, best able to do the necessary job quickly, efficiently and economically, and familiar with their particular needs.

Many of these relationships go considerably further than a flexible working arrangement which may be readily changed or broken as circumstances alter. These permanent arrangements may involve stock-holdings in one financial institution by another, common directorships, or long-term fiscal agency or management contracts. We have enquired into such relationships to find out how they influence flows of funds in the market by their effect on competition. Information on common directorships, which is given in the appendix volume, and on stock ownership was supplemented by conversations with senior officers of the principal institutions concerned.

The most striking feature of these connections is the close link which has developed between chartered banks and trust companies. Close arrangements involving other financial institutions are by no means uncommon: insurance companies, sales finance companies, mutual funds and, to a limited degree, investment dealers, may be associated with each other or with banks or trust companies through common, but not mutually exclusive, directors. There are also instances where investment dealers, for example, either as individuals or as a firm, have substantial share interests in life insurance or sales finance companies. Similarly, at least one sales finance company has control of a life insurance company other than a captive company used to insure its own contracts, and has an interest in a corporation dealing in N.H.A. mortgages; another has a substantial investment in a trust company, while a third has recently taken an interest in an existing mortgage loan company.[44] One life company also has a significant holding in a trust company and others are shareholders of a company interested in developing new and smaller businesses. In these cases, there is a natural tendency for the partners to be favoured, particularly in the under-

[42] Trust companies submission, para. 2.39; Transcript pages 3357-8.

[43] Transcript, page 3362.

[44] In addition, many sales finance companies have established consumer loan company subsidiaries—see Chapter 11.

writing business, but we found no evidence that investment policies were unduly influenced or that competition was significantly impaired by such relationships; indeed, most such companies continued to run very much as independent enterprises.

A number of chartered banks have recently acquired interests in companies operating in the mortgage market as conventional lenders, sometimes in association with sales finance companies, investment dealers, trust companies or other institutions: in one case, a bank and associates have formed a company designed to insure conventional mortgage loans. In addition, a bank and associated dealers, institutions and individuals collectively have a major interest in a mutual fund. Two other banks and three trust companies have joined together to form a company engaged in making term loans to small and medium sized enterprises, while a further two banks have purchased interests in two separate companies making mortgage or longer-term loans to business.

Despite this recent tendency for banks to acquire interests in other financial concerns, however, it is in the relationships between banks and trust companies where the clearest pattern emerges. Moreover, these relationships are becoming both closer and more widespread. Each of the banks has a close association with at least one trust company, some of them loose working relations of long standing and others ownership affiliations of very recent origin. The form of these bank-trust company relations thus varies a good deal: in some cases there are as many as 15 common directors while in others there are few; five banks have an equity investment in at least one affiliate, varying from relatively small holdings to effective control, while the others have no equity investment.[45] Whatever the formal relationship, however, these bank-trust company links are firm enough that each institution is known to work more closely with its affiliate than with other trust companies or banks. Although the associations may not limit the independence of the trust companies or influence the allocation of business as much as is often thought, it is certainly true that the "independent" trust companies have a lively sense of the strength of these relationships.

The principal reason that banks have wished to be closely associated with trust companies is to provide a more complete financial service than they can do under their own act, although much of the recent impetus to closer ownership links has come from a desire either to prevent a trust company associate falling under the control of another trust company allied to a different bank, or to achieve added growth and standing. Another important factor has been the desire of the banks to have associates who are not restricted in their ability to offer competitive deposit rates, and some banks have been attracted by the possibility of participating in the growing profits of the trust companies. Since the legislation keeps the banks out of conventional mortgage lending and trustee business, they have found it advantageous (and profitable where there is ownership) to have a trust company "partner" who can conveniently look after their customer's needs in these areas. The oldest associations, which date from the nineteenth century, were established for just this reason—indeed in one case the trust company was founded by officers of the bank in order to bring better service to their customers even though no bank ownership was or is involved. Each of the partners of these unions can direct business to the other and does so, although no bank or trust company deals exclusively with its affiliate.[46]

While the influence exerted by the banks on the business of affiliated trust companies varies a good deal, it appears that they have not tried to influence the "banking" side of their business beyond assisting their affiliates to obtain good branch locations and, in some instances, urging the trust company to bid for deposits that are going to be lost to the parent bank in any event but which the trust company will at least tempo-

[45] Included in the five is one bank which has an equity in a trust company through its investment in the parent loan company and another whose associated trust company is owned by one of the bank's own parent companies.

[46] Transcript, pages 8227-29.

rarily re-deposit with the affiliate bank. There is no evidence that banks have tried to inhibit trust company growth by limiting their branch expansion or controlling this source of competition in other ways. Indeed, each bank's interest so far has been in seeing that its trust company does well in competition with other affiliated companies. Some of the affiliated companies have thus in fact been particularly aggressive in their deposit and certificate business. Similarly, the banks have not influenced the investment policies of trust companies to any marked degree, although we have heard of cases where the associate is urged to try to meet the needs of bank customers or where the customer himself is pressed to take his trust business to a particular company.

The banks make their presence felt most strongly in the E.T. & A. business, more than 80% of which is in the hands of trust companies affiliated to banks in one way or another. Their power to influence the disposition of corporate bond trustee and transfer business is particularly strong: personal trust business is not much affected, and it was, in fact, suggested that people often prefer to separate their banking and investment or estate management affairs entirely. The corporate E.T. & A. business may, of course, move to the affiliated trust company simply because management finds it convenient, but we were told that the banks often influence the choice in one way or another. While many corporations split this business as a matter of policy, a limited survey showed that anywhere from half to three-quarters of the trust business of larger corporations tends to go to the trust company affiliated with the corporation's principal banker.[47]

We see no reason for concern about the trend to bank-trust company affiliations because of any necessary incompatibility between trust and banking business. At the present time the trust companies do in fact carry on a large part of the business of banking without prejudicing the interests of their trustee customers, while in other countries banks do both kinds of business. If there is a danger, it is that continuation of the present trend might lead to undue concentration and thus to reduced competition in the financial system. The banks are already large and the trust companies collectively are the banks' most important single group of competitors. We shall have more to say about this matter in our recommendations for banking legislation in Chapter 18.

[47] It is sometimes alleged that the trust companies are in a position to control the banks through their E.T. & A. accounts. While in some cases E.T. & A. customers may hold as much as 10% to 15% of the outstanding capital of the affiliated bank, they also hold shares in other banks. Given the trust companies' present share-voting policies and the independence of many E.T. & A. accounts, these holdings of bank shares do not appear to be used as an active instrument in controlling bank policies.

TRUST AND LOAN COMPANY EARNINGS

As already noted, one reason for bank purchases of trust and loan company stock has been the attractive returns available on their investments. The revenues of loan companies have been pretty well determined by the yield available on conventional first mortgages, which provided about 85% of gross revenue in 1961. Their revenues in relation to assets have thus risen steadily with mortgage rates and in 1961 were 6.79% of assets. Because of the relatively simple character of their business, administrative expenses, which have averaged around 1.25% of assets, are low in comparison with other institutions, and have in fact risen less rapidly than the volume of funds administered by loan companies in recent years. On the other hand, their borrowed funds, being predominantly long term, are relatively expensive. The tendency for the less expensive deposits to grow less rapidly than debentures, and some narrowing of debenture rates relative to mortgage yields, have led to a slightly more rapid rise in interest expenses than in revenues with the result that net earnings on each dollar of assets have declined a little. At 2.00% in 1961 they are still, however, high compared to those of the chartered banks (1.11% in 1961 and 1.00% in 1962) and the Quebec Savings Banks (.96% and .88%) and somewhat higher than the trust companies (1.63% in 1961). The return on share-

holders' equity increased from around 5% in 1951 to 8½% in 1961, partly owing to the fact that the ratio of capital to other liabilities has steadily declined. Since 1955, net profit ratios have tended to remain stable although total profits grew by over 50% from 1955 to 1961.

It is more difficult to assess the position of trust companies because there is such variety in their character and because we are not able to separate the earnings from the two main types of business. Although we do have information on the fees and other income received from estate, trust and agency operations, the published statements do not attempt the difficult task of allocating expenses between this and the intermediary business. For this reason we have related all revenues and expenses to the funds employed in the intermediary business (i.e. consolidated company and guaranteed accounts). This amounts to treating E.T. & A. business as a service provided by a financial intermediary, in the same manner as we have treated the revenues and expenses relating to services provided by other institutions.

The common view in the industry is that the "banking" business is more profitable than the management of estate, trust and agency accounts. We were told that the companies try to develop the banking business rapidly in new branches in order "to cover the losses of other departments which take considerably longer to reach the break even point"[48] and that the fiduciary business is costly because of its personal nature, the expenses of developing new business, and the fact that each account must be separately managed. Salary and other administrative expenses are thus high for trust companies: they have run well over 4% of the funds in company and guaranteed accounts in recent years and even in 1961, when assets grew very rapidly and expenses rose less than proportionately, were about 3½%. However, it seems that some parts of the E.T. & A. business, particularly trustee and transfer work in connection with security issues, is very profitable to the companies able to obtain it. For the industry as a whole, moreover, the fees from E.T. & A. accounts have consistently covered a very substantial part of all salary and administrative expenses in spite of the fact that the companies have run into heavy costs from the rapid expansion of their intermediary business. While it

TABLE 10–7

REVENUES AND EXPENSES
(as a percentage of total assets)

	Trust Companies[a]		Loan Companies	
	1955	1961	1955	1961
Revenue				
Fees etc. on ET&A	3.87	2.94	—	—
Interest, dividends and other income including trading profits and losses	4.25	5.58	5.94	6.79
TOTAL	8.12	8.52	5.94	6.79
Less:				
Administrative expenses	4.32	3.42	1.32	1.20
Revenue after administrative expenses	3.80	5.10	4.62	5.58
Less:				
Interest paid	2.12	3.48	2.45	3.58
Net earnings before tax and provisions	1.69	1.63	2.17	2.00
Net write-downs of assets	.02	.09	.04	.10
Taxes	.66	.67	.86	.76
Net profit	1.01	.87	1.27	1.14
Dividends	.51	.39	.73	.63
Retained for shareholders' equity and reserves	.50	.48	.54	.51
Memorandum:				
average rates earned—mortgages	5.80	6.79	6.27	7.32
—bonds and debentures	3.48	4.82	3.42	3.84
paid —deposits	2.10	2.89	2.18	2.72
—certificates and debentures	2.77	4.45	3.61	4.87
TOTAL	2.45	3.84	3.06	4.25

[a]Expressed as a percent of company and guaranteed funds.

[48] Trust Companies' Submission, para. 1.41. See also Transcript, page 3453: ". . . There is no question but that the estates and trust business, for the amount of work done, is not as profitable as the guaranteed accounts."

may take longer to become profitable, it appears that E.T. & A. business does in fact make a worthwhile contribution to the earnings of the companies, even though the amount per dollar of assets under administration is small.

Although E.T. & A. revenues and total administrative expenses have tended to grow less rapidly than total assets, income from the investment of company and guaranteed funds and the interest cost of funds borrowed have, like those of loan companies and other institutions, risen more rapidly. Because a substantial part of their funds are invested in bonds and other assets yielding less than mortgages, this part of revenue has been lower in relation to assets than for the loan companies, although higher than for the banks. The same is true of their rate of net earnings which, while declining somewhat, remains more than ½ of 1% above that of the chartered banks. The rate of return on equity has improved in recent years, rising from under 9% to about 10½% from 1955 to 1961 and again this has been associated with continuous reductions in the capital ratio. Total profits grew by no less than 89% from 1955 to 1961, reflecting the rapid growth of the companies' assets and E.T. & A. business. This trend appears to have accelerated in 1962 and 1963.

The loss ratios of both loan and trust companies have been very low in the post-war period, although during the depression they reached a level of 5% of mortgages, the great majority of them being incurred in connection with farm lending. Despite the low losses in recent years, the companies have urged that the Income Tax Act be amended to allow them more generous untaxed general reserves, although they have also made the somewhat conflicting request that permitted capital ratios be lowered. The Income Tax Act now allows them to allocate ¼ of 1% of the amount of their conventional mortgage holdings to a reserve each year up to a maximum amount of 3%, and the companies recommend raising these limits to ½ of 1% and 6% respectively. At the moment, the companies are not taking full advantage of the existing privilege and the reserves average only about 1¼% of the eligible assets. Since the subject of reserves, like that of capital ratios, has broader implications affecting all institutions, we defer consideration of it until Chapter 19.

Since both the trust and the loan companies have been able to obtain a higher return on their assets than the chartered banks, there seems to be no financial reason why they could not adjust to stiffer bank competition, particularly if they were to be permitted at the same time to move into the unsecured personal and business lending from which they have been precluded. While we will return to this question and to the related subject of bank ownership of trust and loan companies in Chapter 18, we hope that the increasing overlapping of the functions of banks and trust companies, which is bound to occur in any event, will strengthen the forces of competition rather than reduce them.

CONCLUSIONS

The vigorous post-war growth of the trust companies has been due in large measure to their willingness to compete aggressively with the banks in many fields. They have undertaken new activities, expanded their branch networks and offered savings customers attractive rates and convenient terms on their funds. Like the loan companies, they have also benefited from the strong demand for mortgages, a factor which might have led them to grow rapidly even if the banks had not been precluded from conventional mortgage lending. The nature of the banks' liabilities, lending skills, and basic attitudes might not have led them to enter this field on a major scale in the period under review. It will be recalled that they were faced with other pressing demands for much of this time and that although they in fact became heavy mortgage lenders for a while under N.H.A., their holdings of N.H.A. mortgages have not risen since 1959.

Since both the trust and loan companies are free of legal restrictions on the maximum rates of interest they may charge, they have been in a

better position than the banks to compete for funds and this factor has undoubtedly contributed to their high rates of growth, particularly in recent years when the general level of interest rates has also been high. They have been sensitive to restrictive monetary policy and credit conditions, although this has merely slowed their rapid rate of post-war growth.

These companies have also gained some advantage from their freedom from the law requiring chartered banks to hold non-earning cash equal to 8% of deposits and the agreement to hold an additional 7% in treasury bills and day loans. However, the earnings advantage has not been large—perhaps ¼ of 1% of total assets—and even if trust and loan companies had been required to meet similar cash and liquidity rules, their pre-tax earnings rates would still have exceeded the banks' by a comfortable margin.

In summary, then, the growth of the trust and loan companies must be imputed largely to their own efforts and ingenuity and to the underlying structure of the demand for funds, although the 6% ceiling on bank lending rates has also been an important factor in recent years and the conventional mortgage prohibition applying to them has also played a part: the difference in cash ratios, while certainly influencing profitability, cannot be said to have been a major factor. Although collectively the trust and loan companies are now 20% of the size of the banks' Canadian business, this is approximately the position they held at the end of the 1920's and cannot therefore be characterized as a major shift in the evolution of the financial system. What is new, however, is the increased competitiveness of these institutions and the growing similarity between many of their functions and those of the banks. The appropriateness of having completely separate legislation and supervision over two classes of institutions performing many similar functions is thus increasingly open to doubt and raises issues to which we shall return in Chapters 18 and 19.

CHAPTER 11

SALES FINANCE AND CONSUMER LOAN COMPANIES

The sales finance and consumer loan companies were pioneers in the specialized field of consumer credit. The former were established following the first world war to finance automobile sales, and branched out from that activity to the financing of other consumer durables. As new lenders ventured into the field, the companies began to finance purchases of equipment and machinery by businesses. The movement into other types of lending and new forms of activity has accelerated in recent years as a result of slower growth in consumer spending on durables and entry of the banks into the personal lending business. Nevertheless, instalment finance companies still concentrate on consumer credit, particularly automobile credit. The loan companies have dealt almost exclusively with consumers, making cash loans to people not able to obtain credit elsewhere. Their charges on loans under $1,500 are now regulated by the federal government under its jurisdiction over interest rates. Although money-lenders had been in existence since the nation's early years, the first federally-incorporated consumer loan company in Canada was founded only in 1928, and it and its successor company were instrumental in seeking to achieve higher standards and bring about orderly regulation of the business.

Although these companies compete with banks, credit unions and others for lending business, they do not compete as directly with them for the funds they borrow. The companies obtain their funds mainly by selling notes and debentures to other financial institutions and corporations and by borrowing from the chartered banks. Unlike other intermediaries, therefore, they borrow almost exclusively in the central financial markets and actually draw an important part of their funds from other financial institutions. Liability competition with such institutions as the chartered banks, trust and loan companies thus takes place principally in the money and securities markets where the instalment finance and consumer loan companies offer their short, medium and longer-term obligations as an alternative to bank deposits, trust company GIC's and loan company debentures. They do not compete as vigorously for funds from individuals and from smaller non-financial companies which are not active investors in the central markets. This is partly because the companies acts under which the finance companies are incorporated appear to prohibit, or at least do not clearly authorize, acceptance of deposits; the consumer loan companies are explicitly prohibited from taking deposits by the Small Loans Act. To the extent that they borrow from other institutions, finance and small loan companies are in effect a second intermediary standing between final lenders and the final borrowers to whom they extend credit. This is particularly true of the smaller companies which are not able to sell their notes in the market and must therefore rely heavily on bank loans.

Another unique feature of the instalment finance companies is that they are the only major financial institutions which are unregulated by any act other than normal company legislation.

This is partly related to the fact that they rarely obtain funds from the public other than through normal securities issues, but may also be due to the variety of business which they do and to the newness of many of the companies in the industry. Indeed, the sales finance "industry" can be only somewhat vaguely defined, although the Dominion Bureau of Statistics publishes statistics which now include about 150 companies and give quite comprehensive coverage of firms doing a general consumer instalment finance business. These statistics do not, however, encompass wholly-owned subsidiaries of merchandising and manufacturing companies which finance only parent company sales[1] or some of the smaller companies specializing in business loans, factoring, real estate finance, home improvement lending and similar activities which might be included in a more general definition of "finance" companies. Nor do the statistics include an indefinite but almost certainly large number of very small consumer instalment finance companies. A few of these fringe companies have started to deal with the public and this has given rise to regulatory and other problems to which we will return later.

The sales finance industry is highly concentrated: ten companies have about 90% of the business covered by DBS statistics and the four largest companies have some 80%. Most of the other companies are quite small, operating either locally or within one province, with the majority having only one office. However, with the entry of many new companies and rapid growth by smaller firms, the share of business held by large companies has been declining: 18 of the 27 larger companies included in a survey conducted for us by the Federated Council of Sales Finance Companies were founded since 1949.[2] Some of the large companies are controlled by foreign financial corporations but most companies in the industry are controlled by Canadian interests. The Federated Council, formed in 1957 to focus the views of the industry and further its interests, now has 42 members who account for about 70% of the consumer business and 90% of the commercial and industrial lending done by the industry.[3]

Unlike sales finance companies, the consumer loan companies operate under specific legislation. Any money-lender, other than a chartered bank or registered pawnbroker,[4] making personal loans of $1,500 or less and charging more than 1% per month on any loan must apply to the Minister of Finance for a license which is renewable annually under the federal Small Loans Act. The main purpose of this Act, first passed in 1939, is to control the total charges on small cash personal loans, as distinct from the instalment financing of merchandise. Since most of the borrowers who approach loan companies or money-lenders are in financial difficulties and in no position to bargain strongly because no other major lending institutions will normally accommodate them, it is considered necessary to "even out the bargaining power" by prescribing maximum lending rates.[5] The Act sets out a scale of such rates on loans up to $1,500—the limit was raised from $500 in 1957—and places the companies and money-lenders under supervision by the Superintendent of Insurance. Loans in excess of $1,500 are not regulated under the Act, and money-lenders operating entirely above this limit and the larger loans of licensed firms are thus exempt from its provisions.

At the end of 1961 there were 78 money-lenders and five small loan companies licensed under the Act, the only difference between them being the method of incorporation; small loan companies are federally-incorporated while the money-lenders are incorporated by the provinces. The consumer loan business is highly concentrated in the hands of a few firms. At the end of 1961 the 10 largest firms had close to 90% of the assets of all licensees (including their loans in excess of $1,500) and 940 out of a total of

[1] General Motors Acceptance Corporation is included in the D.B.S. statistics, but is not a member of the Federated Council of Sales Finance Companies.

[2] Submission, para. 14.

[3] As defined in the D.B.S. statistics. See also footnote [1].

[4] Pawnbrokers are limited to charging 15% per annum on amounts over $20 by the Pawnbrokers Act. The act also specifies maximum rates on smaller amounts.

[5] Transcript, pages 5558 and 5563.

1,148 branch offices. Three firms alone, one of them a money-lender, had two-thirds of assets and operated 620 branches across the country. At the other extreme, 48 lenders had assets of less than $500,000 each and the majority of these had only one office. Many of the companies are subsidiaries or affiliates of sales finance companies or of foreign-owned consumer loan companies. The largest of these subsidiary companies in fact dominate the field: at the end of 1961 five American-owned companies had 57% of all business and three subsidiaries of Canadian finance companies a further 28%.

Fifty-six of the companies having 99% of the business belong to the Canadian Consumer Loan Association, formed in 1944 to promote the interests of the industry. Since the members are all bound by the provisions of the Small Loans Act, they have a keen interest in seeing that no member or other company, whether or not it is licensed, breaks the law and gives the industry a bad name. The Association in fact actively co-operates with the Superintendent of Insurance in policing the small loans business generally.[6] Nonetheless the Small Loans Act only covers lending in amounts up to $1,500 and does not cover conditional sale contracts.[7] Moreover, a lender may purchase an existing contract, for instance a small mortgage initiated by another lender, yielding more than the regulated rates, although the Superintendent will then take action against the original lender if he has contravened the Act. Thus, in spite of the best efforts of the regulated companies and supervisory authorities there are still many small lenders who are not members of the Association charging higher, sometimes exorbitant, rates on various kinds of consumer lending. In addition, there is an unorganized fringe of similar private lending which would no doubt persist under any regulatory system. We shall have more to say later about steps which should be taken to improve the protection of small borrowers by extending the coverage of the legislation.

[6] Transcript, page 5539 and following.

[7] A conditional sale contract is taken to be a deferred sale of merchandise rather than a loan transaction.

LENDING ACTIVITIES

Although sales finance companies do not lend only to consumers, their growth has been largely determined by the demand for consumer credit and by the extent of competition in that market. In recent years, it has also been strongly influenced by their own willingness to venture into new fields as competition in their traditional areas of business became more intense. Prior to the war, they concentrated mainly on automobile finance and did not meet strong competition because the banks were reluctant to enter this new and specialized lending field. Needless to say, the depression and war years were not favourable to their growth because of widespread unemployment in the first period and shortages of consumer durable goods in the second. However, following 1945, rising levels of income and employment, low levels of personal debt, rising output of durable goods to replace and extend the aging stock of such assets in the hands of consumers, and the other factors affecting the willingness and ability of individuals to incur debt discussed in Chapter 2, led to strong consumer credit demand and rapid growth of the institutions prepared to meet it. As Table 11-1 shows, credit extended by finance and loan companies, by retail dealers either directly or through their affiliated finance companies, by chartered banks and credit unions and by insurance companies all rose sharply. Total consumer credit jumped from $388 million in 1945 to $1,231 million five years later and continued to grow rapidly through succeeding years.

The sales finance companies were the main beneficiaries during the first decade of this expansion, for the most rapid increase was in instalment credit for durable goods which the companies were willing to make available conveniently and easily through the automobile dealer or other retailer at the time of sale. Thus their share of consumer credit rose from 2% in 1945 to a peak of 27% in 1956. The consumer loan companies also expanded rapidly in this ten-year period but credit extended by retail dealers and banks grew more slowly. Table 11-1 also includes the relatively small amount of unsecured lending

TABLE 11–1

MAIN TYPES OF CONSUMER CREDIT OUTSTANDING

(December 31)

—	Sales Finance Companies	Consumer Loan Companies	Retail Dealers	Chartered Banks	Credit Unions & Caisses Populaires[a]	Other[b]	Total
	$ Millions						
1945	8	30[e]	100[e]	73	25	152	388
1950	202	93	454	224	76	182	1,231
1953	516	176	624	308	133	233	1,990
1956	756	356	798	435	209	281	2,835
1957	780	362	826	421	249	308	2,946
1958	768	401	861	553	294	317	3,194
1959	806	484	915	719	363	336	3,623
1960	828	549	960	857	417	358	3,969
1961	756	594	1,006	1,030	503	375	4,264
1962	771	689	1,039	1,183	560[e]	398	4,640
	Percent distribution						
1945	2.1	7.7[e]	25.8[e]	18.8	6.4	39.2	100.0
1950	16.4	7.6	36.9	18.2	6.2	14.8	100.0
1953	25.9	8.8	31.4	15.5	6.7	11.7	100.0
1956	26.7	12.6	28.1	15.3	7.4	9.9	100.0
1957	26.5	12.3	28.0	14.3	8.5	10.5	100.0
1958	24.0	12.6	26.9	17.3	9.2	9.9	100.0
1959	22.2	13.4	25.3	19.8	10.0	9.3	100.0
1960	20.9	13.8	24.2	21.6	10.5	9.0	100.0
1961	17.7	13.9	23.6	24.2	11.8	8.8	100.0
1962	16.6	14.8	22.4	25.5	12.1	8.6	100.0

[a]Includes small amounts of caisses populaires non-personal lending.

[b]Principally insurance company policy loans: also including Quebec Savings Banks.

[e]Estimated.

SOURCES: D.B.S., Bank of Canada and, for the credit unions and caisses populaires, the appendix volume to this report.

by the Quebec Savings Banks and the amount of life insurance policy loans, which accounted for 39% of the total in 1945 but have not grown rapidly since.[8]

Dramatic changes in the consumer credit market have recently resulted from the rapid expansion of chartered bank lending through their personal loan programs. The banks have, of course, lent to consumers for many years and one of them instituted a consumer loan plan during the 1930's, but they have stepped up their activities in recent years. Aided by the 1954 amendment of the Bank Act regarding chattel mortgages, from 1958 on they have moved actively into fields such as instalment financing of cars and other durables in which the sales finance companies had previously met little bank competition. At the same time, the credit unions have taken an increasing share of the market. This sharply increased competition from other lenders, coupled with the slow growth of consumer expenditure on durables, has caused the finance companies' consumer lending to grow very little since 1956 and induced them to move into other fields as well. Consumer loan companies have also been influenced by the changed competitive circumstances, but since their main market is still in cash lending to a class of people

[8] Policy loans did, however, account for about one-quarter of the increase in all consumer credit in 1957. Some of these loans are for business rather than consumer purposes but no classification is available.

who have not been greatly affected by the expanding consumer lending of the banks, these companies have not been exposed to the same pressures. They have experienced more severe competition from the credit unions, but their loans have continued to rise although at a reduced rate.

As the following table shows, consumer credit of all kinds now amounts to about 16% of personal disposable income, a figure which compares to 12-13% before the war. These trends were discussed in Chapter 2, but it is worth noting again that this higher level of debt reflects the cash savings and other conveniences available from many consumer goods, as well as the displacement of regular monthly commitments like laundry bills, transportation, and the like by regular debt repayments on the goods concerned. To the extent that the latter is a factor, the figures exaggerate the real rise that has occurred in the financial commitments of individuals in the postwar period; this is particularly true of the replacement of monthly rent by monthly mortgage payments as home ownership has risen. Despite the increased willingness of consumers to incur debts, however, these may have reached a level where they will expand only gradually in relation to income, and the industry may face an increasingly competitive market in the years ahead.

RATIO OF CONSUMER CREDIT TO PERSONAL DISPOSABLE INCOME

——	Consumer Credit	Personal Disposable Income	Ratio
Year-end	$ mn.	$ mn.	%
1945	388	8,617	4.5
1950	1,231	13,670	9.0
1953	1,990	16,848	11.8
1956	2,835	20,888	13.6
1958	3,194	23,362	13.7
1959	3,623	24,526	14.8
1960	3,969	25,486	15.6
1961	4,264	27,086	15.7
1962	4,640	28,646	16.2

NOTE: If estimated personal mortgage debt were included, the ratio of all consumer debt to personal disposable income would be approximately 50%.

(i) *Sales Finance Companies*

Sales finance companies differ from other financial institutions, including the small loan companies, in that they frequently do not lend directly to the purchasers of the goods being financed. Instead of applying to an institution for credit and receiving the funds in cash to make purchases or pay off bills, the borrower using finance credit rarely deals with the lending company or actually receives cash. The credit is made available by the auto dealer or other retailer at the time of sale in a single transaction with the customer, who signs a conditional sales contract or some other form of deferred payment agreement with the dealer. The dealer then sells the contract to a finance company, which will collect the payments on it, thus completing the transactions by which the company effectively extends credit to his customer. From the customer's point of view the result is the same as in other credit dealings—he has made his purchase and will pay for it over the following months—but the mechanics of doing business are entirely different.

Since finance companies "accept" credit contracts already written, competition among them focuses on their efforts to persuade dealers to bring them retail contracts rather than on direct efforts to attract borrowers, although the companies do a certain amount of advertising. The terms on which they buy the finance agreements from dealers are the most important part of this competition. The customer signs an agreement to pay a specified finance charge in addition to the balance due on his purchase, and the finance company taking over the contract credits part of this charge to the dealer as his payment or commission for having obtained the business for it. Rather than pay him immediately, the company normally credits the amount to a "reserve" account against which losses, or deductions resulting from rapid repayment, are charged. Obviously, dealers will be interested in doing business with the company which is prepared to pay them the best price, and—according to information filed with us—the dealers ordinarily receive 10% to 20% of the total finance charge, the remainder going to the

finance company.[9] Competition among the companies has raised the level of dealer reserves somewhat in recent years.

Another important part of the arrangements with dealers is the sharing of the risk of default. In most cases, the company accepts part of the risk by agreeing to find the goods if the buyer has "skipped", repossess them and deliver them to the dealer who then repurchases the contract, usually by a charge against his reserve with the company. A limited number of "full recourse" agreements leave the full liability with the dealer, while under "non-recourse" agreements, which may be offered as an inducement to dealers but are apparently not common, the finance company accepts all the risk. Finally, in order to protect their own investment and as a necessary service to help dealers close their sales without delay, the companies normally have credit investigation departments to check on prospective customers. They usually require insurance on major durables like automobiles, and many of them provide this automatically through subsidiary or affiliated companies when the contract is written.

In addition, the companies offer dealers a number of other services, the most important of which is the "wholesale" financing of their inventory. Competition for dealer accounts among the companies and with the banks is such that the charges for inventory finance are much lower than the retail rates; in 1961 they varied from 6% to 7% plus a small service charge compared to a range of 12½% to 19% on new car retail contracts and higher rates on used cars and other consumer goods.[10] Nearly all wholesale financing is for automobile inventories (retailers' inventories of other durable goods are often financed by the manufacturers), and large national companies have an advantage in this business for they all have offices close to the manufacturers through which the contracts can be processed. Because this helps them to attract dealer accounts, they thus have some competitive edge over smaller companies in automobile financing as a whole.

Finance companies are also prepared to make capital loans to dealers for the improvement of their facilities, and here as in the wholesale business competition among the companies has kept rates relatively low. However the amounts involved have been small, the ten largest companies reporting $14 million of such loans outstanding to 637 dealers in 1961.[11]

These various lending and other services form a package offered by the companies in order to obtain retail contracts, and although there are some instances where a dealer does business with more than one company, it is more common for him to assign all his retail paper to the company that provides his wholesale finance. Since earnings on these and capital loans are relatively low, a company is unlikely to handle them unless it obtains at least a significant part of the dealer's retail business. Moreover, his sales agreements are made out on forms provided by his company, the finance charges are taken from a rate chart it supplies, and the contracts are purchased at prices arranged with him in advance. No doubt the effective rate his customers must pay for financing has an effect on the dealer's ability to attract business—the success achieved by the banks, which lend at somewhat lower rates, and the fact that dealers are prepared to cut their price, and thus forego part of their reserve, attest to some sensitivity to interest rates. However, the other elements in his relationship with the finance company are of more immediate concern to him. Finance charge competition is, as it were, carried on at one remove, and the charges are less sensitive to changes in credit conditions than rates on wholesale financing which are settled in a more closely competitive market.

The character of the retail finance market is reflected in the wide variety of rates charged by the companies, although these are calculated and negotiated with customers in the form of the total dollar amount of the finance charge rather than a rate of interest. For instance, in 1961 the effective annual charges of 17 companies on a standard new car contract varied from 12.5% to

[9] Supplementary Submission of the Federated Council, pages 19-20.

[10] Based on data in submission of the Federated Council, Tables 4.1 and 4.4.

[11] Submission of the Federated Council, para. 58.

18.8%, with most companies reporting rates from 13.5% to 16%;[12] rates on a smaller consumer contract ranged from 16% to 23%. There is no uniform pattern in the timing, amount and on occasion even the direction of rate changes. Although the companies do not believe their retail customers to be highly sensitive to rates, they do not raise retail rates at all quickly when other rates are rising. Thus, each company sets its charges somewhat independently of others in the course of its competition for dealers and their contracts, although underlying market forces do shape their decisions.

There has been a tendency for the repayment periods on retail contracts to lengthen during the past decade as a result of competition, including that of the banks. The average repayment periods on new automobile contracts of four large companies submitting information rose from a range of 19 months to 21½ months in 1954 to a range of 26 to 30 months in 1961, and the somewhat shorter terms of other retail contracts have also lengthened.[13] One company told us of reducing its term and raising down payments as part of a restrictive policy in 1959,[14] but the available statistics do not show any consistent pattern of changes in response to general monetary conditions. Indeed, the averages for all four companies reported in the submission lengthened in 1959 and 1960, as did the average repayment terms of all finance companies as published by the Dominion Bureau of Statistics.

It is general practice, and required in some provinces, to disclose the dollar amount of finance charges to customers but the companies do not disclose the effective rate of interest. They have objected to doing so because different methods of calculation give different results and all require some arithmetic skill, because the charges include a necessary fee to cover the cost of servicing accounts and the total charges on small amounts thus work out to high rates of interest, and because they find that customers are more interested in the dollar amount to be paid than in the interest rate. In spite of these objections, we believe there is a strong case for disclosure in both forms so that customers may readily compare the cost of funds in contracts which are not identical as to terms and amount. All generally accepted methods of calculation give closely similar results. Moreover, dealers could be provided with rate as well as charge books and would not have to do the arithmetic themselves; and consumers could hardly suffer from having more information. Since this matter of disclosure applies generally, and not only to finance companies, we shall return to it later.

Consumer goods financing accounted for 64% of the finance company receivables included in Table 11-2 in 1955, but for the reasons suggested earlier these assets have not grown rapidly in recent years and by the end of 1962 were down to 54% of the receivables shown. Of this amount, 77% was for new and used automobiles, and 23% for other consumer durables. Commercial vehicle financing and the wholesale business associated with vehicle sales have also grown slowly, and in these circumstances sales finance companies have done much to diversify their business and find new lending markets, particularly by expanding their financing of industrial machinery, by other business lending and by investing in small loan and other subsidiaries.

Equipment financing has grown steadily and is now approaching $300 million, with most loans being for relatively small amounts. The typical contract runs for $5,000 to $15,000 and calls for repayment in two or three years, but some go as high as $500,000 and repayment may stretch over periods up to eight or ten years.[15] Rates of interest, which vary from one company to another and with the size of the loan, appear to range from 10%, and perhaps a little lower on large loans to good

[12] Applying the formula

$$\frac{2CP}{L(n+1)}$$

to finance charges shown in Table 4.1 of the Submission; C=the total finance charge; P=number of payments per year; L=principal amount borrowed; n=total number of monthly payments over the life of the contract.

[13] Federated Council Submission, Table 7.6 to 7.8. See also page 114 of the I.A.C. Submission.

[14] Transcript, page 1659.

[15] Submission of the Federated Council, para. 52-56, Transcript 5366-5370.

TABLE 11–2

SALES FINANCE COMPANIES: MAIN RECEIVABLES[a]

	Consumer Goods			"Wholesale" Finance	Commercial & Industrial			Total
	Cars	Other	Total		Vehicles	Other	Total	
	$ millions							
1951	161	24	186	108	95	33	128	421
1953	411	105	516	115	123	61	184	816
1955	478	121	599	145	106	85	192	936
1957	636	144	780	202	135	153	288	1,269
1959	610	196	806	197	138	206	344	1,346
1961	569	187	756	184	138	257	395	1,335
1962	593	179	771	237	146	279	425	1,433
	Percent distribution							
1951	38.2	5.7	44.2	25.7	22.6	7.8	30.4	100.0
1953	50.4	12.9	63.2	14.1	15.1	7.5	22.5	100.0
1955	51.1	12.9	64.0	15.5	11.3	9.1	20.5	100.0
1957	50.1	11.3	61.5	16.0	10.6	12.1	22.7	100.0
1959	45.3	14.5	59.8	14.6	10.2	15.3	25.5	100.0
1961	42.6	14.0	56.6	13.8	10.3	19.2	29.6	100.0
1962	41.4	12.5	53.8	16.5	10.2	19.5	29.7	100.0

[a]This Table does not include some additional business receivables for which information is not available prior to 1960. A recently published DBS survey of financial institutions indicates that these receivables increased from $77 million at the end of 1960 to $259 million two years later. (See DBS publication No. 61,006.)

borrowers, up to 16% on loans of $5,000 or less.[16] Some companies specialize more than others in this business, either through their regular organizations or in separate business lending divisions. The financing of farm equipment and machinery has been a growing source of business for some companies, with lending particularly focussed on larger items. While the larger companies have not neglected the opportunities available to them, some smaller companies have been particularly successful in equipment financing, their aggressiveness in this direction reflecting to some extent the fact that larger companies have some advantage in automobile financing. A classification submitted to us shows the share of all kinds of financing held by the three largest companies declining, but falling particularly rapidly in commercial and industrial lending.[17]

In addition to this equipment financing, which some companies have done for years and is in many ways similar to consumer goods lending, sales finance companies are moving into many new types of medium-term business lending quite unlike their traditional instalment finance business. Some are doing mortgage lending, some provide interim financing on real estate and construction, and some have established subsidiary companies which will invest in residential and business mortgages up to 80% or more of property value. Finance companies are also engaged in property and equipment leasing, although with the exception of a growing automobile fleet management business which the companies and their dealers are well-equipped to service, equipment leasing is not as widespread as in the United States, partly owing to different taxation treatment.[18] Commercial financing and factoring—the financing of business receivables by lending against them or, in the case of factoring, by purchasing them outright—is also developing and some sales finance companies are competing with the twenty or so small companies which specialize in this type of lending. However, it is not as well-developed a

[16] Supplementary Submission of the Federated Council, pages 11-13.

[17] Tables 2.2 to 2.6, Submission of the Federated Council.

[18] Transcript, pages 5384-89.

business in Canada as in the United States, largely because the chartered banks normally handle such credit needs at rates well below those charged by factors: sales finance company activity is not yet large and the other companies probably do not have assets in excess of $30 or $40 million.

The available statistics on these and other new types of business lending do not give a complete picture of its growth. However, a new DBS publication[19] shows that at the end of 1962 the finance companies had business lending of $259 million (compared to $77 million in December 1960) in addition to the $425 million of commercial vehicle and equipment financing shown in Table 11-2. Growth of the magnitude indicated by these figures has brought the companies into competition with other established lenders. In their submission and at the hearings they expressed particular concern about the rapid expansion of the Industrial Development Bank which they feel to be in direct competition with them. They argue that the I.D.B. has made loans to many businesses which they were willing to finance, although at more than the I.D.B. rate, and cite evidence of I.D.B. funds being used in part to refinance loans they were already carrying.[20] This raises the important question of the proper role of the I.D.B. in relation to the private financial system, a subject which will be taken up in the next chapter.

Finance companies have also diversified their activities by investing in companies ranging from the steel to the trust industries, and by establishing or acquiring subsidiaries in other fields. A number of them have subsidiary insurance companies whose main business is the insuring of their instalment sales contracts but which also engage in a more general business, and one has acquired a substantial interest in an established life insurance company. Another company has diversified by acquiring instalment finance operations in the United States, the Caribbean area, and Western Europe. However the most common form of sales finance company expansion through subsidiaries is for them to move into the consumer loan business.[21] The continued expansion of the latter type of consumer credit and the high returns available in such lending have made diversification in this direction very attractive, and investment in the equity and debt of small loans subsidiaries by the ten largest companies rose from $17 million in 1954 to $141 million in 1961.[22]

(ii) *Consumer Loan Companies*

In contrast to the instalment finance companies, the consumer loan companies have pretty well remained in their traditional field of making cash loans, although some of them also do an instalment finance business. At the end of 1961, 71% of the companies' main assets were in loans under $1,500 which were subject to regulation, 22% in larger cash loans and 7% in conditional sale agreements. By contrast, before the level to which the Small Loans Act applies was raised from $500 to $1,500 in 1957 about three-quarters of the companies' cash lending was unregulated.

Within the regulated small loans category itself, there is a tendency for the average size of loan to rise—the average loan was for $429 in 1961 compared to $282 in 1957—but it is striking that a very low proportion of loans is made in the $1,000 to $1,500 range. This is not because there is little demand for loans over $1,000—about one-quarter all cash lending is in amounts over $1,500—but because the companies find the ½ of 1% a month maximum rate allowed on balances in the $1,000 to $1,500 range barely covers their cost of funds and in fact involves them in losses after administrative and bad debt expenses. On balances up to $300 they may charge a maximum of 2% per month, reflecting the higher relative costs of administering and initiating these loans, while on balances from $300 to $1,000 the maximum is 1% a

[19] Publication No. 61.006: *Business Financial Statistics, Selected Financial Institutions.*

[20] See the Supplementary Submission of the Federated Council, pages 30-41.

[21] For subsidiaries of the ten largest sales finance companies, see supplementary submission, pp. 2 and 3.

[22] *Ibid.*, pages 16-18.

TABLE 11–3

PRINCIPAL ASSETS OF CONSUMER LOAN COMPANIES

—	Small[a] Loans	Loans over $1,500	Sub-total	Conditional Sale Agreements	Total
			$ millions		
1951	—	—	114	—	114
1955	—	—	273	16	289
1958	316	66	382	31	413
1959	360	86	446	46	492
1960	392	112	504	52	556
1961	426	133	559	42	601
			percent distribution		
1951	—	—	100.0	—	100.0
1955	—	—	94.5	5.5	100.0
1958	76.5	16.0	92.5	7.5	100.0
1959	73.2	17.5	90.7	9.3	100.0
1960	70.5	20.1	90.6	9.4	100.0
1961	70.9	22.1	93.0	7.0	100.0

[a]That is loans up to $1,500. Data for earlier years not shown because the definition of small loans was raised from $500 in 1957.

SOURCE: Reports of the Superintendent of Insurance. Small amounts of conditional sales financing for business customers are included and the totals are therefore somewhat larger than the consumer credit figure shown in Table 11–1.

month.[23] On unregulated loans over $1,500 the companies' rates seem to average about 1½% monthly. Thus the scale of permitted rates distorts the availability of loans within the regulated field, while there is no regulation of the substantial amount of larger lending. It is most important to protect small borrowers but we think it desirable that a more realistic rate structure be adopted and that it apply not only to the consumer loan companies but also to other personal lenders, and will make recommendations to that effect in Chapter 19.

Most people who approach the loan companies are not in a position to borrow from another institutional lender because of their relatively low income levels and high debts. About 80% of loans are made to those with monthly incomes

[23] In their submission to us the Canadian Consumer Loan Association indicate for instance that the maximum charges on a $1,000 loan work out to an annual rate of 17.76% and those on a $1,500 loan are 15.24%. Some methods of calculation give slightly higher annual yields.

SIZE DISTRIBUTION OF NEW LOANS DURING 1961

—	Number of loans	Amount
Up to $300	33.2%	11.8%
$300 to $500	17.9%	12.9%
$500 to $1,000	46.9%	70.7%
$1,000 to $1,500	2.0%	4.5%

SOURCE: *Report of the Superintendent of Insurance, 1961.*

below $500, many of them clerical and relatively unskilled workers, while 75% of the amount lent in 1961 was to people who were already borrowing from consumer loan companies. The Act is designed to protect these unsophisticated borrowers by prohibiting the making of two loans to different members of one family in order to take advantage of the higher maximum rates on smaller loans. It also specifies that an increase in an original loan which brings the combined total over $1,500 shall continue to be regulated, but we were told by both the companies and the Superintendent of Insurance, who administers the Act, that it was considered perfectly legitimate to pay off an existing loan first and then replace it with an unregulated loan of more than $1,500. This seems to us illogical, and we recommend that future legislation be designed to prohibit the practice.

The companies interview applicants carefully and in practice accept only about one-half of them. In some cities they have set up information centres to insure that no one borrows from more than two companies but each company carries out its own investigation. Debt consolidation and payment for such essentials as clothing, medical care and household upkeep are common reasons for borrowing, but the companies also make substantial amounts of small loans for less pressing purposes—travel and holiday expenses and automobile purchases each accounted for 11% of loans in 1960 and the latter accounted for a considerably higher proportion of the dollar amounts lent.[24]

[24] See Table 6, submission of the Canadian Consumer Loan Association.

As a general rule, all loans under $1,500 are made at the maximum permitted rates, and are granted for the maximum term permitted by the Act. The companies may not charge more than 1% per month on loans of $500 or less made for a period longer than 20 months or on loans from $500 to $1,500 made for longer than 30 months, the idea being that these longer loans are cheaper to administer in relation to the balances outstanding. There is very little price or term competition in this rather special part of the financial system, although such competition does enter into the unregulated business. The companies therefore rely heavily on advertising, convenient location of well-marked offices in shopping districts, and rapid, efficient service to attract customers. In fact, the number of branches in the industry has risen almost as fast as the volume of business for just this reason, having almost doubled in the seven years ending in 1961 to the point where the industry now has a quarter as many offices as the chartered banks.

SOURCES OF FUNDS

In their early years, sales finance companies obtained most of their funds either from stock issues and retained earnings or by bank borrowing. Prior to World War II there were only a few public debt issues, some of which were retired during the war when the total business of the companies declined. However, their rapid post-war expansion led them to supplement equity and bank funds by the issue of a wide variety of notes, bonds and debentures, and about two-thirds of the liabilities of larger companies are now in this form. On the other hand, smaller companies with less ready access to the main financial markets continue to rely heavily on bank loans and equity.

The finance companies were the first substantial borrowers other than the federal government in the Canadian short-term market, and their efforts to develop and improve this source of funds have contributed much to its growth. Indeed, they are still the largest single group of

TABLE 11–4

LIABILITIES OF SALES FINANCE COMPANIES[a]

—	Bank Loans	Short Term Notes	Long Term Notes[b]	Bonds and Debentures	Other Liabilities[c]	Capital and Reserves	Total
			$ Millions				
1953, 10 largest companies	191	212	140	104	108	84	839
1957, 10 largest companies	156	409	227	193	158	143	1,286
1962, 10 largest companies	90	515	691		277	241	1,814
1962, all other companies	65	49	44		37	47	242
1962, TOTAL	155	564	735		314	288	2,056
			percent distribution				
1953, 10 largest companies	22.8	25.2	16.7	12.4	12.9	10.0	100.0
1957, 10 largest companies	12.1	31.8	17.7	15.0	12.3	11.1	100.0
1962, 10 largest companies	5.0	28.4	38.1		15.3	13.3	100.0
1962, all other companies	26.9	20.2	18.2		15.3	19.4	100.0
1962, TOTAL	7.5	27.4	35.7		15.3	14.0	100.0

[a]The 10 largest companies are those reported in the submission of the Federated Council of Sales Finance Companies. Data for 1953 and 1957 are from Table 6–1 of the submission and refer to fiscal year ends. Calendar year end data for 1962 are from the D.B.S. survey of sales finance companies.

[b]Two years and over.

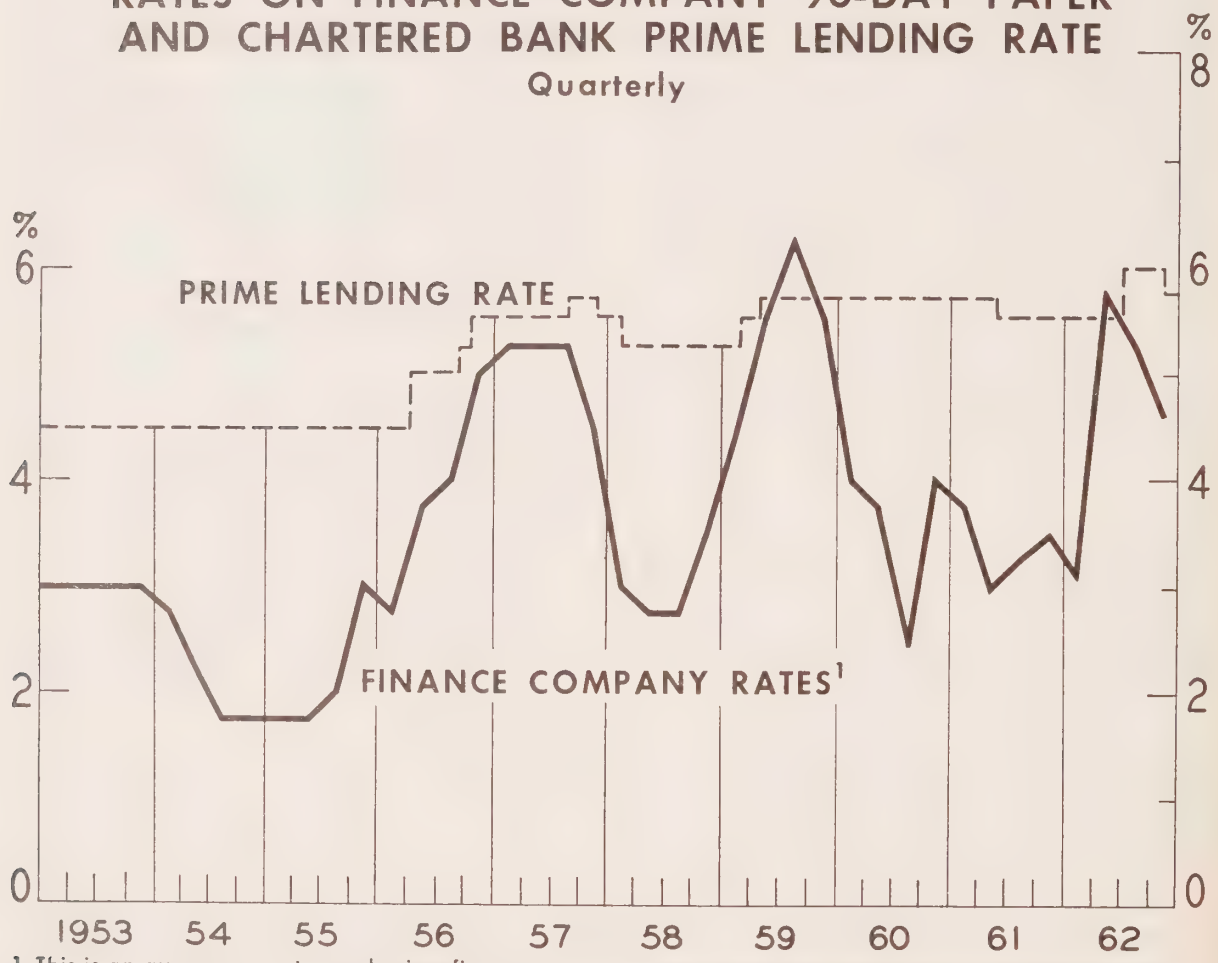
[c]Principally accounts payable, unearned service charges and dealer reserves.

borrowers in the money market despite the many others who have since entered it, and more than one-half of all outstanding short-term paper is normally issued by twenty sales finance companies who are regular borrowers, a high proportion being issued by a few large companies. As indicated in Chapter 7, the companies have developed this alternative to short-term bank accommodation both because the interest cost is usually lower and because their bank lines of credit were severely cut back in periods of credit restraint. As Chart 11-1 shows, the sensitive rates on their paper come down to levels well below the more inflexible chartered bank lending rate in periods of easy money, providing a strong incentive to borrow outside the banks. Moreover when bank funds were cheaper than market rates for fairly brief periods in episodes of tight credit conditions, the restrictions on bank lines prompted them to rely more heavily on non-bank sources.

Chart 11-1

RATES ON FINANCE COMPANY 90-DAY PAPER AND CHARTERED BANK PRIME LENDING RATE

Quarterly



1. This is an average quarter-end prime finance company rate: some companies were paying higher rates, particularly at peaks in the interest rate cycle.

Data supplied by the ten largest sales finance companies showed that their bank credit lines were cut by 21% in 1956-57 and by 50% from 1959 to early 1960, although outstanding amounts of loans actually rose in both periods and the share of lines in use rose from 52% to 81% in the first episode and from 26% to 91% in the second.[25] Similar information from the consumer loan companies revealed the same pattern: lines of the biggest companies were cut by more than 20% in the first period and by 10% in the second. For the smallest companies surveyed, however, there was actually an increase in 1956-57, although their credit lines were sharply curtailed in 1959-60; in contrast to the sales finance companies, use of these reduced borrowing rights showed a mixed pattern of increases and decreases.[26]

Most of the market paper issued by the companies is sold through investment dealers, although there has been a trend towards private placements and some companies now sell most or all of their paper in this way. The companies post rates at which they are prepared to borrow for the standard under one-year maturities; some also regularly take funds on terms up to six years while others will occasionally negotiate the size and terms for such medium-term borrowing to suit the lender. Because the market now includes a large number of Canadian and American investors who are accustomed to using finance company paper as a short-term investment, the finance companies find it a reliable source of short-term funds. They may at times have to pay high rates and do a more strenuous selling job to attract lenders, but only in rare instances has the market "dried up" for a particular company and even then not for more than a few days.[27]

In addition to their short-term paper, the finance companies issue secured notes and debentures for terms up to 20 years. The notes are sold primarily to insurance companies and other financial institutions, while the debentures, which are not specifically secured and normally yield slightly more, are acquired by individuals as well. This long-term debt is usually sold through underwriting syndicates managed by the companies' fiscal agents although direct placements have occurred. Part of the increase in long-term debt shown in Table 11-4 has resulted from efforts by the companies to anticipate future needs by borrowing long in years such as 1958 when interest rates are relatively low, but as a general rule they have not obtained their long-term funds at low rates. This is because it is during periods of easy money and slack demand in the economy that the volume of their lending business is least favourable and short-term debt is already being reduced by the proceeds of maturing sales finance contracts. The companies are unwilling to reduce their short debt too much for fear of losing their borrowing lines at the banks and weakening their short-term market contacts. Thus, more of their long-term issues were sold in periods like 1956-7 and 1959 when the demands on finance companies were strong, bank lines of credit were under restraint and the companies were anxious to assure themselves of adequate funds to meet the needs which they foresaw.

A number of companies have also issued long-term notes and debentures and invested the funds in readily marketable securities at lower yields in order to provide a cushion of liquidity to replace that formerly provided by bank lines. Since the companies do not feel they can rely on their bank lines of credit as they once did, their holdings of marketable securities rose from virtually nothing in 1957 to about $100 million, or 6% of assets, in 1959, and have fluctuated between $50 and $100 million since then.[28] The companies which have invested in marketable securities ap-

[25] Submission of Federated Council of Sales Finance Companies, Table 6:5. The reductions amounted to $69 million from the end of 1955 to March 1957 and to $194 million in the year ending March 1960.

[26] Submission of Canadian Consumer Loan Association, Table 24.

[27] Transcript pages 1630, 5437-39.

[28] Earlier figures relate to the ten largest companies only.

parently feel that the cost involved is reasonable, and did not generally accept a recent offer by the banks of firm lines of credit for six months in return for a fee. The companies hold this liquidity partly as a reserve to meet unexpected business demands and partly to guard against temporary difficulties in raising funds in the short-term market; it also serves as a reassurance to money-market lenders that they will be able to redeem their commercial paper at maturity even though bank lines may have been curtailed.

Whatever their own views about the form of their borrowing, the finance companies' freedom is restricted by the terms of trust deeds covering their notes, debentures and other debt. Although the companies are not subject to any legislative borrowing limits, apart from the implied or specific prohibition on taking deposits, the underwriters and the investors on whom they rely for funds in effect impose what they consider a sound capital structure. The terms of trust deeds are not uniform, but a common rule is that unsecured debt must not exceed shareholders' equity and that secured debt should not be more than four times the sum of equity and unsecured debt. Thus in the normal case a finance company is subject to an effective 10% minimum capital ratio, a figure higher than that of other financial intermediaries but less than that applying to non-financial borrowers, which of course do not have such a diversified portfolio of liquid receivables; the actual capital ratio for the industry as a whole at the end of 1962 was 14%.

These limits on capital structure, together with the lenders' scrutiny of the receivables put up as security for the notes and the normal examination of prospectuses by the securities commissions, provide the main protection to those lending to finance companies. So long as the companies draw their funds from well-informed investors able to judge their soundness, or even from the general public through the securities markets where a satisfactory prospectus is required, there does not appear to be any reason to impose inspection and supervision comparable to that applying to banks, trust and loan companies, credit unions and other institutions which borrow generally from the public by means of deposits. However, this freedom from government inspection cannot safely be extended to firms which do accept such funds or their practical equivalent from the public: in the life of this Commission we have had more than one instance of serious abuse and some provincial governments have taken steps to prevent recurrences. We do not conclude from these experiences that all finance companies—using the term very generally—should be precluded from taking deposits. Nevertheless, quite apart from fraudulent enterprises, there are many small and over-extended firms in the industry which got into the business in the days before competition stiffened. As long as these firms deal with the banks or other skilled lenders, or raise funds purely from friends and associates, no problem of the public interest is involved. If however, finance companies generally are to get into the taking of deposits, they clearly must be able to meet high and continuing standards of supervision and inspection in the same way as other institutions doing a similar business.

In contrast to the instalment finance companies, the small loans industry has not substantially changed its financing sources in recent years. Table 11-5 shows that its capital structure is relatively uncomplicated. Large companies obtain funds from their American parent or Canadian instalment finance company owner and small companies rely mainly on the chartered banks and their own shareholders. Some of the larger companies have sold short-term market paper but the amount is relatively small for the industry as a whole. The larger independent companies usually borrow short initially and then fund into long-term debt once they are reasonably certain that the higher volume of business will continue. Capital ratios are slightly below those in the sales finance industry, but since the distinction between shareholders' equity and long-term debt held by the parent is fairly artificial in the case of the wholly-owned subsidiaries which account for so

TABLE 11–5

LIABILITIES OF CONSUMER LOAN COMPANIES[a]

	Owing to Parent and Associated Companies	Bank Loans	Short Term Notes	Other	Shareholders' Equity	Total
	$ millions					
Dec. 31st						
1960	333	72	31	35	54	526
1961	367	49	39	38	62	557
1962	404	51	59	46	74	633
	percent distribution					
1960	63.3	13.7	5.9	6.7	10.3	100.0
1961	65.9	8.8	7.0	6.8	11.1	100.0
1962	63.8	8.1	9.3	7.3	11.7	100.0

[a]DBS, *Business Financial Statistics, Balance Sheets*, publication No. 61,006. This new survey covers about 90% of the industry: we use it in this table because other sources do not break down borrowings into the main categories shown here.

much of the industry, this figure can only be regarded as approximate.

REVENUES AND EXPENSES

Because of the high expenses associated with numerous small branch offices and the initiation, processing and collection of small loans, the administrative expenses of the consumer loan companies are the highest of any class of financial institution. As a result of improving efficiency and some reduction in advertising outlays, these expenses have declined a little in relation to total assets during recent years, although they are still close to 7%. In addition, bad debt losses are high compared to those of other institutions, but appear to have stabilized at around 1% of assets, the level experienced by the more mature American industry. Gross revenues of the companies, meanwhile, have declined somewhat because of the higher ceiling on the size of regulated loans as well as the growth of large loan business and conditional sale agreements which yield less than the typical-sized small loan. Nevertheless, at 17.6% of assets in 1961 they are considerably higher than those of the sales finance companies, which were about 11% on a comparable basis,[29] and well over the gross revenues of the major financial institutions doing a lower-cost and lower-risk business. Reflecting the nature of the consumer loan companies' business and the long-term character of their liabilities, interest costs are also higher than those of other institutions, amounting to 4.7% of assets in 1961 compared to under half as much for the chartered and savings banks and about 3½% for trust and mortgage loan companies.

Nevertheless, net profits after taxes remain high compared to other major institutions and at

[29] Revenues reported to us by the sales finance companies are net of dealer reserves and other costs of acquisition of business which together probably amount to about 1½% of assets.

REVENUES AND EXPENSES

(percent of total assets)

	Sales Finance Companies[b]			Consumer Loan Companies[c]	
	1954	1957	1961	1957	1961
Revenue[a]	10.1%	9.7%	9.7%	18.0%	17.6%
Less: administrative expenses	3.2	2.7	2.7	7.7	6.8
NET	6.9	7.0	6.9	10.3	10.8
Less: interest on borrowed funds	3.2	3.9	3.7	4.1	4.7
NET	3.7	3.1	3.2	6.2	6.1
Provision for losses and reserves, net	0.5	0.3	0.5	1.1	1.1
Taxes	1.6	1.3	1.4	2.3	2.6
Net Profit	1.6	1.5	1.4	2.9	2.4
Dividends	1.1	0.9	0.9	0.9	1.5
Retained Earnings	0.5	0.6	0.5	2.0	0.9

[a]See footnote [29].

[b]Ten large companies.

[c]Prior to 1957 the definition of small loans was different so that the revenues and expenses reported by the Superintendent of Insurance are not comparable with later years.

2.4% of assets are more than double those of the mortgage loan companies. Profits in relation to equity also appear to be more than double those of mortgage loan companies and the banks, the latter of which operate with much lower equity ratios. It is therefore not surprising that sales finance companies have been attracted into the personal loan business and that increasing competition has already started to bring about a noticeable decline in profit rates.

In spite of increased competition in the consumer field and the shift to business lending, on which rates are generally lower, the gross revenue of the sales finance companies has declined only marginally in relation to assets in recent years. The average rate earned on all wholesale financing has dropped by 1¼% to about 6½% since 1954, but retail rates have actually risen slightly to about 11¼%, net of dealer reserves, reflecting the somewhat higher rates charged on lower quality consumer business in which the banks are not active competitors. Administrative expenses have declined relatively as the companies have been under pressure to improve efficiency, and at 2.7% of assets are about ½ of 1% above those of the banks; they would be considerably higher if dealer reserves were included in the figures. Interest on borrowed funds, at 3¾% of assets, is 2% above that of the banks but not much higher than that paid by the trust and loan companies. The inability to borrow by deposits is a factor in these higher costs and explains why some companies are anxious to receive deposit-taking powers, although the greater share of longer-term debt with which the industry would almost certainly continue to operate in any event is also a factor.

Reflecting the riskier business which demand and competitive factors have led the companies to undertake, loss ratios appear to have risen very slightly on the average in recent years. While at ½ of 1% of assets these are considerably above those of the banks, they are less than half those of the consumer loan companies and have been kept manageable by the companies' efficient credit-rating and collection systems. Net profits per dollar of assets have been reduced in the last decade by the competition of new entrants and other institutions and by the shift towards business lending. The rate of return on equity has declined from 14.2% in 1954 to about 11% currently, at which level it is still above that of most intermediaries. Since the volume of business of the industry has, however, continued to grow, total profits of the ten leading companies have increased despite these lower margins, from just under $19 million in 1957 to $22¼ million in 1961. Margins may well fall somewhat further in future since it does not appear that the competitive adjustment of market shares with other institutions is yet complete, and the companies may lose further ground relatively.

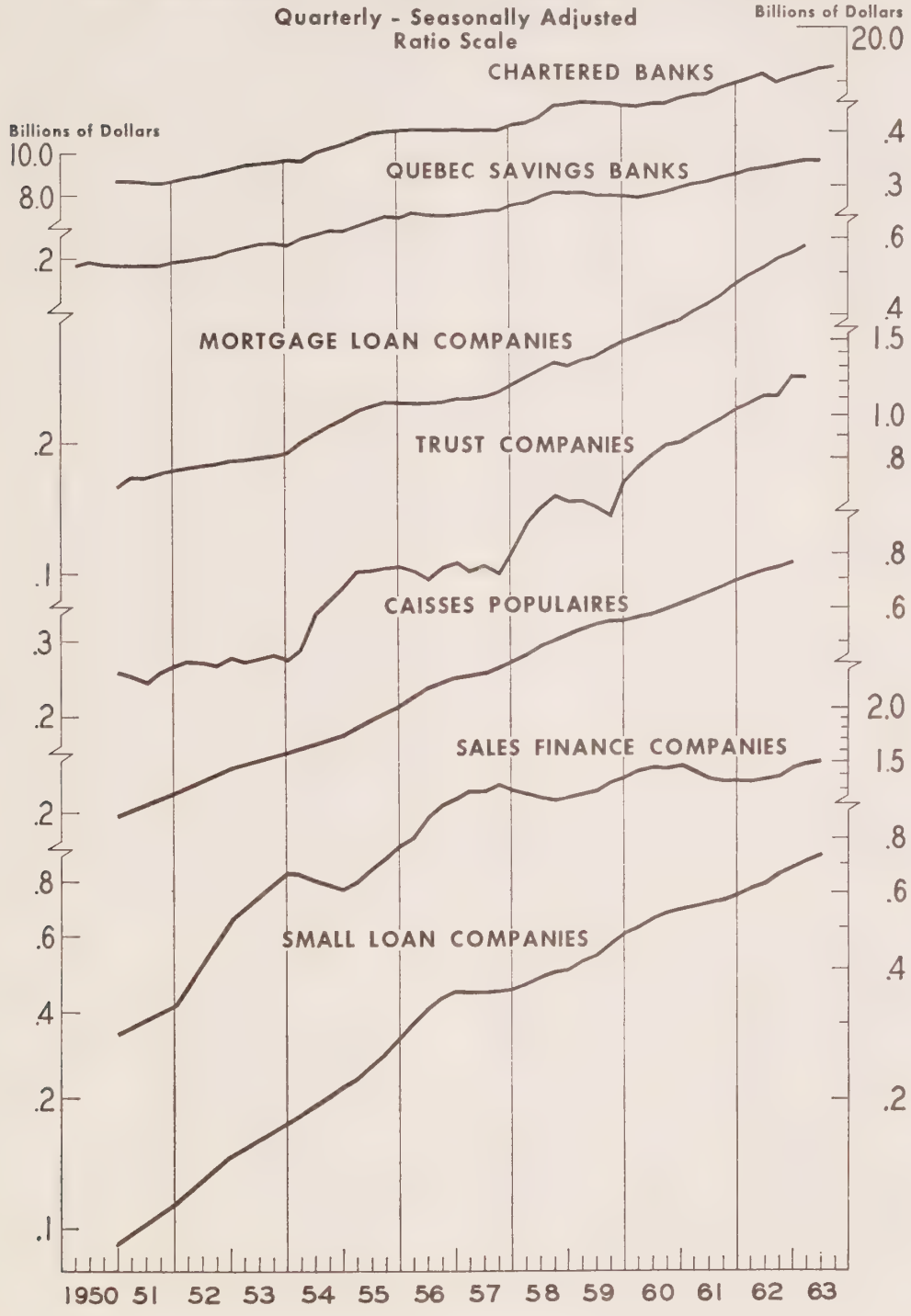
FINANCE AND LOAN COMPANIES IN CREDIT CYCLES

The cyclical behaviour of the sales finance and consumer loan companies has been strikingly different from that of the institutions discussed in previous chapters. Although the others do not all respond identically to changes in monetary policy, it has generally been true that high levels of interest rates have been associated with a slowing in their growth, or even an absolute decline in their assets, and with tighter restrictions on the terms and amounts of credit available to those who borrow from them. Indeed, the restriction of the institutions' growth and higher rates of interest are the two essential characteristics of periods of credit restraint. Chart 11-2 compares the growth rates of the main short-term financial institutions discussed in this and preceding chapters. In order to bring out the cyclical behaviour of each type of institution more clearly we have estimated the trend of each series and removed it by expressing each original observation as a percent of the trend value at the same date. We must emphasize that the long-run trends cannot be precisely and definitely calculated, but we believe that the estimates of cyclical fluctuation shown in Chart

Chart 11-2

THE GROWTH OF SELECTED FINANCIAL INSTITUTIONS

Quarterly - Seasonally Adjusted
Ratio Scale

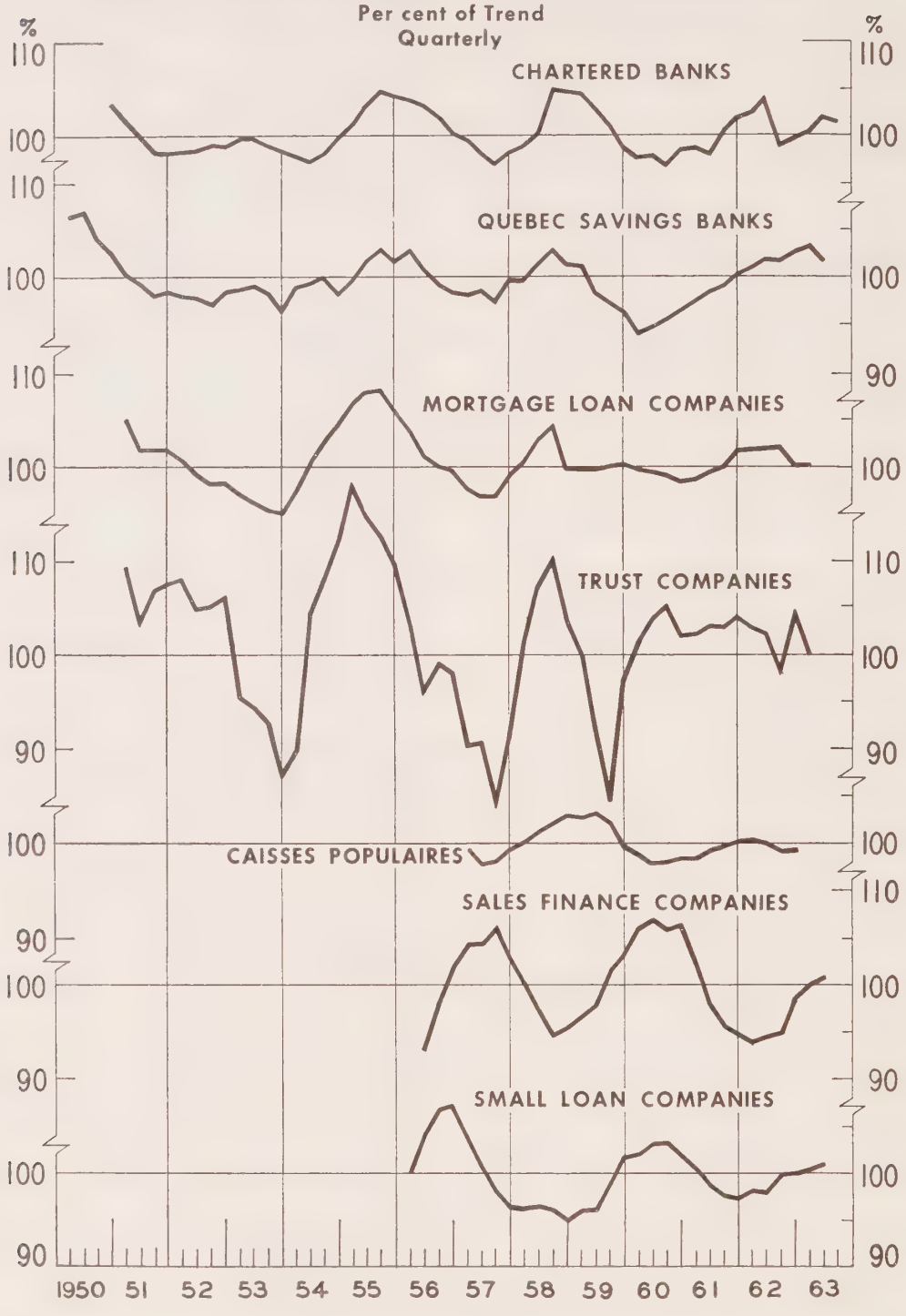


75319—15

Chart 11-3

FINANCIAL INSTITUTIONS : CYCLICAL FLUCTUATIONS

Per cent of Trend
Quarterly



11-3 fairly represent the behaviour of each institutional group.[30]

The cyclical behaviour of all institutions but the sales finance and small loan companies has been broadly similar. In periods of restraint such as 1955-57 and 1959 their rates of growth have fallen sharply when the central bank has brought pressure to bear on the system's cash reserves and interest rates have risen. Similarly, they all tend to expand rapidly at the same time, as in 1954-55 and 1958. On the other hand, the assets of sales finance and consumer loan companies have grown more rapidly than usual in years such as 1956 and 1959 when interest rates were high and the total resources of the other institutions were under pressure, and have grown less rapidly or declined in periods of easier money.

This is not because the companies' earnings and growth are unaffected by the higher cost of funds associated with monetary restraint. However, the business of sales finance and consumer loan companies has been much more influenced by the demand for funds from their customers than by the cost and availability of funds from holders of their liabilities. Consumer demands for credit—like those in all sectors—have been strongest in economic expansions when consumers are optimistic and have high demands for automobiles and other durable goods, and consumers seem more prepared than others to pay relatively high rates of interest for the credit needed to go ahead with their purchases. Thus, institutions specializing in lending to them are able to take on earning assets quickly and, because the yields on these assets are high, are able to pay the high rates necessary to attract funds even in periods of credit restraint. Moreover, finance companies are able to charge higher rates on their business lending than the banks are permitted. The process is made easier for them by the fact that they rely for funds mainly on a limited number of sophisticated lenders in the central financial markets; these lenders, being much more sensitive to rates than the general public from whom other institutions borrow relatively heavily, will make substantial amounts of additional funds available to the companies if attractive rates are offered.

This, of course, is how a price system should work. The cyclical behaviour of the liabilities of sales finance and consumer loan companies shows that funds do flow to the borrowers willing to pay most for them, particularly when rates are high and funds are limited. Thus, the fact that lending by sales finance and consumer loan companies rose in the tight credit conditions of 1956-57 and 1959 is not evidence of a failure in the workings of general monetary policy but of an appropriate response to market forces. It should also be recalled that bank lending was rising through much of this period in response to rising loan demand from both business and consumers, even though the total assets of the banks did not grow significantly. The banks were able to finance this increased lending by running down their holdings of more liquid assets in which, unlike the finance companies, they find it profitable to invest on a large scale when loan demand is weak. A comparison of the growth of the sales finance companies' receivables with that in bank general loans in the periods of most rapid cyclical increase, when total bank assets were under restraint, shows that from mid-1955 to

[30] The growth of sales finance companies in recent years is underestimated as the series used does not include the "other receivables" item for which information is not available prior to 1960. Cyclical indexes for the caisses populaires are not calculated prior to 1957 because quarterly data is not available although annual data is available for earlier years to aid in estimating the trend. Because of the pronounced change in the growth rates of sales finance and small loan companies in 1956-57 we have not been able to calculate trends for the entire period: despite the difficulty of estimating a trend for such a short period we believe that the cyclical fluctuations shown in Chart 11-3 are broadly accurate.

The following seasonally adjusted quarterly series are used in Charts 11-2 and 11-3:

Chartered Banks:	currency and total chartered bank deposits.
Quebec Savings Banks:	deposit liabilities.
Mortgage Loan Companies:	deposits and debentures of 4 companies; see the appendix volume.
Trust Companies:	deposits and certificates of 11 companies; see the appendix volume.
Caisses Populaires:	deposits of the Fédération de Québec des Caisses Populaires Desjardins.
Sales Finance Companies:	the receivables shown in Table 11-2 of this chapter.
Small Loan Companies:	total loans.

75319—15½

mid-1956 the increase in bank loans was $875 million, or about 27%, compared to an increase for the companies of $279 million, or 31%. In the year ending in September 1959, bank loans actually rose more rapidly, 23% against 9% for finance company receivables; the absolute increases were $950 million and $110 million respectively.

Thus, although the total assets of the companies and the banks behave differently during much of a period of restraint, their lending response has been much the same. In the latter stages of such periods, however, after the banks' lending has virtually ceased to grow, the finance companies have continued to increase their receivables, particularly from business, because of their continued ability to attract funds. For example, the banks' loans rose by 5% from mid-1956 to mid-1957 while the instalment finance companies increased their receivables 16%.[31] In the six months following September 1959 when the banks' general loans declined about 3% after allowance for seasonal variations, finance company receivables rose a further $85 million or 6%. It may be that in future the sales finance companies will be somewhat more sensitive to credit restraint in view of the increasingly close competition with the banks on both sides of their business, and in particular because their reduced margins make it more painful than formerly to absorb the increased cost of funds.

The assets of consumer loan companies have also increased more rapidly in periods of monetary restraint than in other years. They expanded by about $80 million in 1956 and 1959, the rates of increase being 28% and 21% respectively, compared to rates varying from 2% to 13% in the intervening years. The rates charged by consumer loan companies do not increase much in such periods, being at or near the maximum in any event for all regulated loans, but the lower per-unit administrative expenses of this increased business volume enable them to compete profitably for the extra funds they need, though in some cases with reduced profit margins.

Despite this growth, the record and their evidence before us make it clear that sales finance and consumer loan companies are still affected by changes in the financial climate. We have already referred to changes in the structure of sales finance company liabilities which have resulted from their ingenuity in developing cheaper sources of funds and from restriction of their bank loans in periods of tight money. Bank loans are the only main source of their funds which is not responsive to higher interest rates, partly because of the existence of the 6% ceiling. It will be recalled that bank borrowing actually increased despite the cuts in bank lines in periods of tight credit, but the companies able to do so turned to other sources, particularly the market for their short-term paper. The short-term notes of the ten instalment finance companies surveyed rose from $238 million at the end of 1955 to $331 million a year later and $444 million in mid-1957. However, even for these companies with ready access to the market, funds could only be obtained at rates running as high as 6¼% on 30-day paper and 7⅛% on one-year paper in mid-1957 and mid-1959.

For reasons suggested earlier, the companies also committed themselves to long-term borrowings at high rates, and in some cases borrowed abroad.[32] Smaller finance and loan companies not having the option of market financing even at these rates or having no access to funds through parent companies, were more severely affected by the reduced availability of bank loans, in spite of the fact that the banks did not cut back as sharply on them as on large companies and have in fact exempted small accounts from the cuts in credit lines. There is no evidence that, as between the larger companies, American-owned firms fare particularly well in times of tight credit conditions: larger Canadian firms, and even a few smaller ones, have easy access to the New York market and make use of this source of funds whenever they find it attractive to do so.

[31] Because of the latter's smaller absolute size, the dollar amounts of the two increases were not much different, about $200 million for the banks and $180 million for finance companies.

[32] *Ibid.*, Tables 6:8 to 6:10.

Since the cost of funds did not deter consumer lending as much as desired, the Bank of Canada called representatives of the industry together in 1956 to propose an agreement directly limiting the expansion of credit. Such "voluntary" consumer credit controls were not in fact imposed because agreement among all companies could not be reached, and the authorities apparently did not think the situation serious enough to warrant special legislation. Selective credit controls, whether imposed by law or by agreement, aim at limiting credit flows by interfering with market forces and are designed to extend the range and impact of changes in credit conditions without affecting interest rates significantly. The question of whether such controls would make a substantial contribution to reducing consumer spending in a boom and of whether they are desirable in a market economy will be dealt with in our comments on financial policy.

With pressures building up on the cost and availability of funds, and direct and indirect attempts being made by the authorities to restrict their lending, finance companies have not been able to carry on through periods of credit restraint without changing their lending policies. Some smaller companies have been faced with an urgent need to retrench, and have done so in spite of their desire to maintain their markets and continue to serve them. Larger companies, whose business dominates the industry, have been able to delay adjustments by turning to alternative sources of funds, but they too have altered their lending policies.

Wholesale lending policies appear to be altered first, both by raising the rates charged and by advising dealers to cut back on their inventories.[33] This is done either in circulars sent to them periodically or by direct contact from the company's regional superintendents or branch managers. However, the available data on wholesale lending indicate that these loans are not substantially affected by the changes in finance company policies. Their policy towards retail paper adjusts more slowly and with even less certainty. Thus the information supplied by the Federated Council shows the average of rates charged by the larger companies on a standard automobile contract rose from 16.2% in 1955 to 17.6% in 1956, but some companies apparently made no change in this period. In 1959, partly because of the competitive factors mentioned earlier, the average of reported rates rose only from 17.0% to 17.2% with 7 of 15 companies reporting no change.[34] While the companies tend to adjust both their wholesale and business lending rates to short-term changes in market rates, the consumer retail rates are less sensitive, moving more in line with longer-term changes in rate levels than with short-run developments.

In addition to adjusting their lending rates, the companies have taken such steps as sending circular letters to branches admonishing them to try and reduce dealer inventories and to tighten credit standards in retail lending. Circulars of this sort were sent out in 1956 and were strengthened during the year, including instructions to branches in some cases not to allow their outstandings to increase. The same approach was adopted in 1959, but as with the chartered banks it is difficult to judge the effect of such circulars. Outstanding amounts of credit continued to rise, although purchases of new consumer paper stopped increasing in mid-1956 and again towards the end of 1959, after allowance for seasonal movements. On the other hand, purchases of new commercial and industrial paper rose sharply in 1956 and again in 1959, and outstanding amounts continued to rise for longer than consumer credit.

Like the banks and other institutions, the companies are under competitive pressure to look after their dealers and other customers when business is good. Indeed, even if individual transactions are only marginally profitable, the companies must take a longer view. They cannot pull out of the business altogether, even for quite brief periods, and it is not surprising, therefore, that there are lags in their responsiveness to

[33] Submission of the Federated Council, Tables 4.4 and 4.5 as well as Transcript pages 1635-7, 1657.

[34] See submission of the Federated Council, Table 4.1. The rates quoted are a simple average of rates reported in the table and are not weighted by the amounts of business done at different rates.

changing credit conditions and that their business policy does not change completely when adjustments are made. Even more than the banks, whose reactions are also delayed and incomplete, the companies are affected by demand factors. Cyclical increases in their assets thus come to an end not primarily because of the state of financial markets and shortages of funds, although they have some influence, but because the demand for automobiles and the other goods they finance ultimately weakens. The situation of consumer loan companies is essentially similar, although they appear to make no major changes in their lending policies or in the freedom with which they grant credit, except for smaller companies which find themselves short of funds because of the reduced availability of bank credit. Subsidiary companies of Canadian and American firms are able to obtain all the funds they need from their parents and appear to be little affected by such difficulties.

CONCLUSION

The growth of personal demand for cash loans and credit to finance a variety of consumption needs, the willingness of the consumer loan and instalment finance companies to meet this demand in a convenient and easy way, and the diversification of the lending activities of the latter companies, have brought the two industries from small beginnings a generation ago to a position of prominence in the financial system. While competition from banks and credit unions in particular is continuing to have an effect on their profitability and growth, and may even lead to the winding-up or merger of some of the weaker units, the companies in general are in a strong position to continue to serve the needs of many borrowers. Moreover, many sales finance companies have carried on the pioneering tradition into which they were born and have moved actively into areas of farm, business and mortgage credit where there is a need for more aggressive and venturesome lending. They have also diversified their borrowing, and we will later have something to say about their deposit-taking powers.

The finance companies have said that they would welcome closer contacts than have so far been established with the Bank of Canada. Since such contacts would lead to a better understanding of the development of central bank policies and to improved co-operation when necessary in executing them, and since they would also improve the Bank's understanding of the industry's practices and problems, we believe they would be helpful to all concerned.

CHAPTER 12

SPECIAL CREDIT FACILITIES FOR SMALLER BUSINESS, AGRICULTURE AND EXPORTERS

The particular financial needs of small businesses, farmers and exporters have not always been completely met by the main security markets and the principal financial institutions already described. While these institutions supply the bulk of such borrowers' needs in the ordinary course of business, newer and more specialized private intermediaries have also developed to serve them. In addition governments have intervened to assist these borrowers either by insuring private loans or by direct lending.

SMALL BUSINESS FINANCE

In Chapter 3 we expressed the view that the substantial increase in the amounts and variety of finance available to small businesses has prevented the emergence of a serious gap in our financial system comparable to that found in the United Kingdom in the 1930's. However, evidence placed before us suggests that there is still room for improvement in the facilities serving the special needs of some of these borrowers.

In the area of short-term finance, the chartered banks are the main institutional source of funds for small as for larger businesses. We have already noted the tendency for banks to lend an increasing share of their resources to smaller borrowers, while many larger businesses have developed alternative sources of credit. Small businesses also obtain short-term accommodation from finance companies or such specialized enterprises as commercial financing and factoring companies. However, the quite modest growth and amount of these types of short-term credit (except in certain special areas such as automobile inventory financing) is evidence that most small businesses find the banks able to meet the bulk of their short-term requirements.

Bank term lending to smaller enterprises is, however, much more modest. On September 30, 1962, only $165 million of the $1,385 million of loans outstanding under lines of credit below $100,000 had been formally negotiated for repayment over periods longer than one year, although the share of funds lent on a term basis was slightly higher than in larger accounts and a sizable part of the remaining $1,220 million was undoubtedly used to help in financing capital expenditures stretching over a number of years. The banks have not expanded their formal term lending particularly rapidly because, as we indicated in Chapter 7, their traditional preferences incline them to direct their limited funds to short-term accommodation, while the 6% interest rate ceiling and mortgage prohibition have prevented them from levying the charges and obtaining the security appropriate to term lending to smaller borrowers. Medium and long-term lending by the chartered banks has thus fallen short of the needs of smaller businesses, and many other private and public sources of credit have consequently grown up to meet them.

In 1960, the Parliament of Canada enacted a Small Businesses Loans Act intended to increase the flow of bank term lending for plant and equip-

ment expenditures by providing a guarantee on loans with a maximum term of ten years. Firms with annual gross revenue of less than $250,000 may borrow up to $25,000 at an interest rate of 5½%, and in September 1963, $51 million of such loans were outstanding, principally to finance the improvement of premises. However, many of these loans would undoubtedly have been granted in the regular way in any event. There have been suggestions that the size limit should be raised and that eligibility should be based on total assets or a higher volume of sales. Any method of definition raises difficulties because of differences in the character of various types of business, but if the guarantee is to be maintained—a matter to which we return later—there might be advantage in a more flexible approach to eligibility.

"Small Business" is at best a vague term, but for present purposes it can be defined by reference to one of the financing problems such enterprises meet, namely that they are too small to sell equity and long-term debt issues in the capital markets where larger firms obtain a substantial part of their external financing requirements. As mentioned in Chapter 16, very few issues of less than $250,000 are sold, except to finance speculative oil and mining ventures. Some smaller industrial issues have been marketed (some of a speculative nature being sold at very high prices in relation to tangible assets or earnings) but in general this manner of financing is costly and unsuitable and is unlikely to become much more common for small companies than at present. For this reason the owners of new and established small firms must supplement bank borowings, their own funds and those of family and friends by turning to other institutional investors.

We have already noted in earlier chapters the growth of business lending by sales finance companies and the limited amount of such lending done by some credit unions.[1] The former lend both to their established customers, like automobile dealers, and to new clients wishing to invest in plant and equipment, although these borrowers are not all small businesses on any narrow definition of the term. Indeed, some finance companies regularly make loans of $250,000 to $500,000 but they deal mainly with businesses needing smaller amounts of medium and long-term credit. With almost $700 million of business lending outstanding at the end of 1962, equal to 27% of chartered bank business loans under lines of credit below $1 million and 52% of the amount lent under authorizations of less than $100,000, the finance companies have become a very important source of funds for smaller businesses.[2] The bulk of lending is either conditional sales financing of equipment purchases or the financing of plant acquisition and expansion, usually against mortgage security. Some finance company lending extends for 10 years or more, but most is intermediate-term credit to be paid off over five years or less. In shorter-term lending, finance companies and commercial financing firms now lend against receivables to various types of business, including small retail stores, which are thus better able to compete with larger stores having their own sales finance facilities for customers.

These institutions have not so far made equity investments other than in subsidiary financial concerns. Nor do they provide the management advice which a number of witnesses told us is frequently more important than additional financing to small businesses dependent on the abilities of one or at most a few people. They are thus straight lending institutions like the banks, although dealing with a somewhat different group of business customers. The sales finance companies and credit unions usually charge higher interest rates and are free to take all types of business mortgage security.[3] Some finance companies have set up separate divisions or subsidiary companies to handle particular

[1] Trust and loan companies also provide funds for businesses through investment in equity, bonds and mortgages.

[2] We have no size classification of finance company lending comparable to that available for the banks, but virtually all of it is in amounts of $1 million or less and a substantial part is known to be in loans of $100,000 or less.

[3] Some provincial legislation restricts the type and size of business loans which credit unions may extend. Much of their business lending is in the form of loans to co-operatives.

types of business lending for they find that the job of assessing the risks of advancing term funds to small firms requires special selectivity and skills.[4] The trust and life companies are also active suppliers of mortgage funds to smaller enterprises, but usually confine their operations to loans on factories and premises, some of which are of course leased rather than owned by small business. One life company, which has specialized in the field in the United States, purchases debt securities in amounts as small as $100,000 although it reports such business as slow in Canada. Most of the other companies believe that the volume of potential business is not high enough to offset the extra costs of acquiring special expertise in this field.

The need for specialized lending skills in dealing with small business financing was one of the reasons which led two chartered banks and three trust companies to join forces in 1962 to establish a subsidiary company, RoyNat Ltd., to provide "expanding and new Canadian businesses with financing beyond the normal scope of banking facilities". Through this company, the partners are able to combine the advantages of their extensive branch systems, the source of much of its business, with a specialized staff of bankers, accountants, engineers, lawyers and others in six offices across the country. The company is also free to take mortgage security—and normally does so—and to charge the rates above 6% which are appropriate to its business: its lending rates have so far ranged from 7¾% to 8½% and the average length of its loans, which are made for terms of from 3 to 10 years, has been 8½ years. As a matter of policy, it does not lend less than $25,000, and in its first year of business did not grant loans larger than $1 million, the average size being about $150,000. The company has some equity investments but participations are relatively small, control is avoided and directors are not appointed to borrowers' boards. At April 30, 1963, loans and accepted commitments of $15.9 million were outstanding and additional commitments of $5.4 million had been made to potential customers. Since its investments now exceed the original capitalization of $10 million, the company has started to borrow by issuing short-term market notes and longer-term obligations.

Another small business company recently founded by a group of 27 shareholders including insurance companies, banks and other financial and non-financial concerns, was also set up in the belief that specialists could better handle the risks and complexities of such financing than could any of its shareholders individually. Canadian Enterprise Development Corporation Limited (C.E.D.) operates in a manner similar to American Research and Development, one of its shareholders, and takes an equity position in each firm in which it invests, usually indirectly in the form of convertible debt. The Corporation has no objection to acquiring control of a company if the owners are willing to give it up, its main aims being to assist new Canadian firms or to help in establishing them when promising ideas come to its attention as well as to provide equity and long-term debt funds to established companies with particular growth potential. Although its interest centres on situations in which management is of better than average ability, the company is prepared to give technical and business advice to companies in which it invests—sometimes by using the facilities of the shareholders—and expects to have a voice in their affairs through its equity participation and appointed directors. It thus differs in concept from RoyNat, which is essentially a term-lending institution. In its first 10 months of operation, it made 4 investments totalling under $500,000, having chosen to move slowly until experience is gained.

A number of other development companies also seek equity investments in promising small companies, a notable example being the Canadian subsidiary of a British company, the Charterhouse Group Limited. Charterhouse, incorporated federally in 1953, has provided long-term debt as well as equity capital in amounts ranging up to $500,000. Unlike C.E.D., it is in-

[4] It will be recalled from Chapter 3 that the overall profitability of small business is slightly lower than larger businesses and that there are more loss companies; the job of selecting the good lending risks—which show above average profits—is therefore not an easy one, particularly in view of the personal nature of management.

terested only in established companies, but in common with C.E.D. its selection of investments depends very much on the quality of management and earnings prospects; the formal security offered for loans is a secondary consideration. At the time of its submission to us, it had accepted only 24 out of 1,100 formal applications and many more inquiries which did not reach the application stage. This acceptance rate is about the same as C.E.D. has experienced in its short life: the most common reason for refusing an application is a lack of competent management in the firm. There are a number of other private development companies active in Canada, many of them sponsored by foreign interests, and having varying investment policies[5] but they have not expanded rapidly. Among the reasons are the competition for such business from other less specialized lenders and the unwillingness of the owners of small enterprises to give up any equity to outside interests, even when a development company or other institution wishes to increase the firm's capital as a condition of granting long-term loans.

In addition to these and other private sources of funds, there are provincial and federal government agencies which lend to small businesses. The provincial development funds and similar facilities have been set up to assist local businesses unable to obtain funds from other sources, including the federal Industrial Development Bank. Some—as in New Brunswick, Newfoundland and Saskatchewan—may either lend directly or guarantee the repayment of funds to other lenders; in contrast, the Ontario Development Agency confines itself to guarantees, while still other provincial agencies make only direct loans. Their rates of interest are usually relatively low, indeed lower than the I.D.B. lending rate which is itself below those of competing private institutions. The term of loans is frequently limited by legislation to 10 years, but in at least one case may be for as long as 20 years.[6] The provinces' main aim is to assist small businesses, but some are prepared to guarantee quite substantial bond issues.

The General Investment Corporation recently established in Quebec jointly by the provincial government and private interests is intended to promote the expansion of manufacturing and other industrial development in the province. It stands prepared to provide equity funds or lend to applicants depending on the circumstances, being particularly interested in assisting medium-sized businesses which are expected to grow rapidly. Its first three transactions averaged about $700,000. Thus the Corporation's objectives differ substantially from those of the direct provincial agencies in other parts of the country, although it may well provide assistance to smaller enterprises as it develops.

Some of these agencies also go beyond lending or guarantee activities, the Alberta Provincial Marketing Board for example having a subsidiary which buys materials for small businesses, often at advantageous prices, and holds them until needed. By requiring only a partial cash deposit, this agency relieves smaller companies of part of the cost of carrying inventory. Moreover, the Alberta Treasury Branches also invest a substantial share of the funds collected in their deposit accounts in loans. In 1961, $23 million of the $38 million of Treasury Branch loans were to small businesses, and a further $7 million were to farmers' and feeders' associations. This was by a considerable margin the largest amount lent to businesses by any provincial agency. The government of Manitoba provides management advice as well as financial assistance to small enterprises through its Development Fund. Considerable emphasis is laid on attempts to foster balanced economic development in the province as a whole and on regional economic problems within the province. About two-thirds of the Development Fund's lending has been in small centres and rural areas where the government has also promoted Community Development Corporations to pool local resources for industrial invest-

[5] See submission of the Charterhouse Group Canada Limited for a partial list.

[6] The Industrial Establishments Promotion Act of Prince Edward Island.

ment.[7] In Nova Scotia, Industrial Estates Limited was set up in 1957 to promote secondary manufacturing and reduce the need for equity funds by building plants for lease and financing purchases of equipment. The new Ontario agency, in common with some others, is prepared to assist companies with technical and other advice. Thus the provinces provide help for small businesses in many ways, although the outstanding amount of advances or guarantees is not very large, probably not in excess of $50 million, and their policies have become more selective as the I.D.B. has broadened its activities.

The original federal legislation which established the Industrial Development Bank in 1944 generally confined its activities to lending to manufacturers. Subsequent amendments have broadened its field until in 1961 it was empowered to lend to virtually any business, although the act still requires that the applicant cannot obtain funds elsewhere "on reasonable terms and conditions". Similarly, the Bank's permitted business is broadly defined: it is able to take any class of security for its loans, may guarantee loans by others, invest in equities and participate in underwritings. In practice, the guarantee power has not been frequently used, I.D.B.'s equity investments have been quite limited for the reasons suggested earlier,[8] and its first and only underwriting occurred quite recently. There may well be occasion to use these powers more fully, particularly by participating in underwritings of issues even smaller than the $1 million offering in which it recently shared, but its main function will probably continue to be direct term lending.

During the nineteen years from its establishment until September 1963, the I.D.B. approved 10,131 loans (2,347 being additional credits to firms already borrowing from it) for a total of $542 million. In September 1963, there were $201 million of loans outstanding to 5,105 customers, and further commitments of $32 million had not yet been disbursed.[9] Most loans are for relatively small amounts—over the 19 years 49% were for $25,000 or less and 90% were for $100,000 or less. However, there is no limit on the size of individual loans, and loans over $100,000, including 24 in excess of $1 million, have accounted for almost one half of the dollar amount approved. There has been a tendency for the share of small loans to rise, partly as a result of increased lending to non-manufacturing firms whose capital requirements are smaller, but perhaps also because medium-sized firms are finding it somewhat easier to obtain term financing from private sources. The average term for which I.D.B. loans are granted has lengthened somewhat and in 1962 was about 7 years compared to 5½ years in 1950, with some loans being made for as long as 15 years.

SIZE DISTRIBUTION OF ALL I.D.B. LOAN APPROVALS

(to September 30, 1963)

	Number of Loans		Amount	
		%	$'000	%
$ 5,000 or less	491	4.8	1,816	0.3
5,000 to 25,000	4,466	44.1	69,265	12.8
25,000 to 50,000	2,453	24.2	94,856	17.5
50,000 to 100,000	1,688	16.7	127,384	23.5
100,000 to 200,000	691	6.8	102,434	18.9
Over $200,000	342	3.4	146,404	27.0
TOTAL	10,131	100.0	542,159	100.0

The broadening of I.D.B.'s lending powers has contributed to a very rapid expansion since 1961, the amount of lending approved having jumped from $35.5 million in the 1960 fiscal year to $71.2 million in 1961 and $92.0 million in 1962. Part of this was a temporary surge as newly eligible borrowers came into the Bank, and at $80 million, the amount of approvals was lower in 1963 than in 1962. However, lending

[7] Submission of the Government of Manitoba, Chapter VI.

[8] The Bank had equity investments of $273,000 on September 30, 1962 and the largest holding reported at any fiscal year end was $308,000 in 1948.

[9] 1963 annual report of the Industrial Development Bank. The submission of I.D.B. to this commission contains comprehensive statistics on the Bank's operations up to September 30, 1962.

to new types of borrower does not fully account for the recent rapid growth: lending to others has also been expanded substantially with loan approvals to manufacturers—which averaged about $25 million a year from 1956 until 1960—being $48 million in 1961, $38 million in 1962 and $37 million in 1963. The Bank has increased its branch system and staff from 6 and 162 respectively in 1958 to 23 and 495 in 1963, has advertised its facilities more widely and has in general become a more aggressive institution. Although the I.D.B. is formally a subsidiary of the Bank of Canada, these and other changes have been matters of government policy; general management and credit approvals, are, however, carried out independently of the government by the I.D.B. board and staff.

Prior to the recent changes in policy, I.D.B. was frequently criticized for being too conservative, for having unnecessarily slow credit investigation procedures and for an inordinate appetite for tangible security. For instance, the Canadian Manufacturers' Association referred to complaints made by some of its members.[10] There are undoubtedly cases in which these criticisms are justified and the loss ratio of ½ of 1%, while not negligible, is moderate for an institution deemed to operate in areas beyond the risk-taking ability of conventional lenders. However, care is essential in all lending to smaller businesses. Moreover, the time taken for investigations reported to us by the I.D.B. does not seem excessive and has been shortened.[11]

Indeed, I.D.B. has now come under attack from the other side. Private lenders, particularly the sales finance companies, charge that the Bank has become too liberal in its lending and now offers unfair and unnecessary competition to private lenders. The heart of this criticism lies in the interpretation of Section 15 of its Act which states that the Bank may only lend if "credit or other financial resources would not be available on reasonable terms and conditions", a phrase which is nowhere defined in the legislation or the Bank's credit application forms. Those approaching I.D.B. for credit are nonetheless required to certify that credit cannot be obtained elsewhere on reasonable terms and conditions, which representatives of the Bank told us was interpreted to include an assessment of the reasonableness of the repayment period, amount, rate, and other characteristics of competing credit offers. They told us that the Bank will make loans if in its view private lenders are not willing to extend credit for as long as may be appropriate in particular cases or to lend as much as the applicant wants and can obtain from the I.D.B., and that their lending decisions very seldom turn solely on a view that private credit, when available, is too costly.[12]

On the other hand, the critics emphasize that the low cost of the funds obtained from the Bank of Canada and its freedom from taxation enable the I.D.B. to charge less than private lenders must obtain if they are to operate profitably. I.D.B. is financed by Bank of Canada investment in its equity and debentures, the latter in six-year serial form sold at a rate equal to the yield on comparable Government bonds plus a margin now set at .60%. The rate on debentures, which was 3½% below the I.D.B.'s average rate on new loans in 1955, has risen more rapidly than lending rates, and in the second half of 1962 was only about 1½% below the average rate of 6.54% earned on new loans. After realized losses, the return on capital and reserves (which were about 26% of all liabilities in September 1963) has consequently fallen to about 2½% in 1963, although this result stems in part from unusually heavy branch opening expenses. Clearly no comparable private taxpaying corporation, even with a smaller equity base and access to short-term funds, could operate profitably at I.D.B. lending rates.[13]

Critics of the I.D.B. argue that it is in an anomalous position as "lender of last resort" when its rates, which have varied from the low

[10] Submission of the C.M.A., paragraphs 72-76 and Appendix IV.

[11] Transcript, pages 8702-8703.

[12] Transcript 8679-80, and 8690.

[13] If I.D.B. were to earn about 8% on its capital after taxes, its total charges to borrowers would have to be in the range of 8% to 10%, depending on the assumptions made about capital structure and the amount allowed for the unusually heavy expenses in recent years.

of 5% maintained until February 1951 to the 7% now in force, give borrowers a strong incentive not to look for alternative sources. The problem, which is inherent in any government program specifically intended to aid particular borrowers who have difficulties in the private market, was less acute in earlier years. At that time there were few if any specialized small business lenders, finance companies were much less active in the field than now and the chartered banks were in practice the only alternative source of finance. In these circumstances a bank's refusal to lend could be taken as evidence that funds were not reasonably available, particularly as I.D.B. rates were then, as now, maintained above those charged by banks. The appearance of new private lenders making funds available at a variety of higher rates has greatly altered the situation. The I.D.B. must now take account of all these lenders and its decisions must reflect a continuing series of judgments about the level at which the cost and other terms of private funds justifies its intervening.

No matter where the I.D.B. rate is set, some lenders who would charge more are bound to be unhappy, as will some borrowers who would like to pay less. If there is to be an I.D.B. at all, it cannot avoid difficult decisions. For example, particular care must be taken to ensure that it does not subsidize some borrowers to the detriment of competing firms which are financed in the private market. More generally, if the aim of government policy is not to extend subsidies but to increase the flow of funds, private and public, into areas not adequately served by existing private lenders, I.D.B. must be wary of inhibiting developments in the private financial system. If it lends actively at relatively low rates, its operations may have this effect. Competition from I.D.B. has induced other lenders to lower their rates but it is very probable that the finance companies, development companies and others who now lend substantial amounts to small businesses at rates well below those charged in earlier years would not have developed their facilities as much if I.D.B. had always been seeking business aggressively for its own account.

In present circumstances, when comparable credit is available from private sources at rates ranging upwards from 7%, the I.D.B. rate of 7% is perhaps too low. Although there is no reason for its prime rate to be the highest in the market, it would be more appropriate for the Bank to be lending at rates ranging up to perhaps 2% over its prime rate and overlapping with the rates charged by other lenders. There are admittedly problems in charging different rates to different customers, but we nonetheless think it appropriate that I.D.B. should not restrict itself to a single rate regardless of the circumstances. No doubt many small I.D.B. loans must be made at rates too low to yield a profit in view of their higher unit costs of investigation, but rates should give some recognition to differing costs and risks. Moreover, we think it desirable that the I.D.B. prime rate should be varied more frequently with changes in comparable private rates than has been the case. We were told that there is no close connection between monetary policy and I.D.B. lending rates, although the general state of credit conditions is taken into account when setting them.[14] However, the announcement of a rate change may on occasion serve to confirm the authorities' general views about credit policy.

Thus, the I.D.B. rate should be set to enable the Bank to supplement private lending, but not to replace it or to inhibit desirable initiative in the private financial system. In line with this broad policy, the Bank should do its best to assist customers in meeting their needs from private lenders. Evidence put before us suggests that the Bank does less of this than it used to. Indeed, the finance companies cited a number of instances of I.D.B. taking over their accounts or granting loans of amounts and terms which they were quite prepared to meet, although at a higher rate. In a submission to us they cited 25 instances of their loans being paid out with I.D.B. funds, the

[14] Transcript, pp. 8689 ff.

total amount being $1.2 million,[15] and a further $2 million or so of business which they had solicited and in many cases approved but which subsequently was taken by I.D.B. Representatives of the Bank themselves told us that when established I.D.B. customers wish to obtain a new or larger loan they are not always asked to apply to other institutions first: the Bank in effect decides itself that reasonable terms and conditions are unlikely to be met outside.[16]

We believe that the Bank should be more insistent that its applicants make strenuous efforts to obtain funds elsewhere, being prepared if necessary to help them do so. In this connection, it should co-operate to the fullest extent with other agencies—insofar as it can without favouring particular institutions—in order to encourage the development of additional financing facilities for small businesses and to ensure that small businesses are in a position to make the fullest use of existing sources. Although it is important to ensure that smaller businesses are not unfairly affected by credit restraint, we believe that I.D.B. should be careful also to ensure that its lending activities in such periods do not lead it to expand its position at the expense of other institutions or to weaken the effectiveness of broader policies. In the past, its lending has not been closely related to national credit policy—rapid expansion taking place during the restraint in 1962 for example.[17]

We would not want these comments to be taken as a condemnation of the I.D.B. We believe it has performed a valuable role in our financial system and we agree with its President that it will continue to do so. Nevertheless, the private financial system in which it operates is also evolving and it is important that the Bank's policies take full account of these changes. Our recommendations are intended to suggest a useful direction for its own evolution, not only as a lender of last resort, but as an active agent in encouraging constructive private developments and in helping the managers of smaller enterprises to take advantage of them.

We favour the present arrangement under which I.D.B. is a subsidiary of the Bank of Canada, since this appears to shield it from interference with its exercise of sound business judgment. However, its activities are on the fringe of the areas of main concern for the money managers of the country, and we feel some changes could usefully be made to provide I.D.B. with its own full-time chief executive officer and to free the Governor of the Bank of Canada from direct responsibility in this connection. While the board and executive committee of the I.D.B. might include some Bank of Canada directors and would certainly include some central bank officers, they should be made up of directors suited to the I.D.B.'s quite different functions. The I.D.B. would continue to be financed through the Bank of Canada: we see no advantage at present in its obtaining all or part of its funds through public sale of debentures. It has been suggested that this would provide a "market test" of the cost of funds but in view of the government guarantee which I.D.B. issues would carry, at least implicitly, their rates would not reflect the borrowing costs of a comparable private institution. On the other hand, there is no strong reason to preclude I.D.B. from public borrowing if it is found convenient to do so for any reason.

It is clear that there is no general shortage of small business financing facilities in Canada, that many of the problems of modest-sized enterprises are managerial rather than financial, and that a part of such problem as does exist results from an unwillingness of the owners to sell any share of the business and its potential profits to those from whom long-term, high-risk funds are sought. Some witnesses indeed expressed the view that there is too much credit available to small businesses, particularly in construction and retail trade, and others claimed that funds were always available to deserving borrowers. Nonetheless, we believe that medium and long-term facilities could

[15] In some cases it may be good practice to consolidate a borrowers' financing by paying off existing debt out of an I.D.B. loan extended for a longer term than the private lender is prepared to grant.

[16] Transcript, page 8710-11.

[17] In part, this expansion was the result of the earlier branch openings and legislative changes mentioned previously.

be further improved. Government institutions can further this process by encouraging, or at least not inhibiting, constructive developments in the private sector. The aim of government institutions should not be to get the maximum number of loans on their books. Rather, it should be to ensure that businesses which can be competitive and profitable have access on a reasonable basis both to a variety of sources of funds and to guidance in planning their financial affairs.

FARM CREDIT AND THE USE OF GOVERNMENT GUARANTEES

In many countries there are private financial institutions which specialize in farm credit. In Canada, despite the importance of agriculture, there are no such institutions although many intermediaries allocate part of their resources to farm credit. Credit unions, insurance companies and trust and loan companies all invest in farm mortgages, although all but the first have reduced their farm lending since the 1930's. Credit unions, finance companies and the chartered banks extend medium and short-term credit. The banks are by a wide margin the largest institutional lenders to farmers, in part because government guarantees of medium-term loans have been available to them under the Farm Improvement Loans Act. In some provinces, notably Saskatchewan, credit unions devote a substantial part of their resources to farm lending. In addition, the feed, fertilizer, equipment manufacturing and other companies selling to farmers extend them credit either directly or through subsidiary finance companies, and private individuals are also an important source of farm credit.

Private lending, in addition to being encouraged by government guarantees, has been supplemented by direct federal and provincial lending through a variety of special agencies. As we noted in Chapter 3, the volume of long-term lending by governments, almost $500 million out of an estimated $825 million of long-term credit and $1,803 million of all types of farm credit outstanding in 1961, indicates that private lending has not been adequate.[18] At the same time, however, the availability of relatively inexpensive funds from governments has greatly reduced the opportunities for private lending, and institutions such as the loan companies which were substantial farm mortgage lenders in earlier years have made no attempt to re-establish themselves on a large scale in this rather specialized line of business.

The Canadian Farm Loan Board was established in 1929 to make mortgage loans to farmers. Except for a few years during the 1930's when it refinanced farmers' outstanding debts, the volume of lending was small and disbursements did not exceed $5 million between 1938 and 1952. Amendments to the legislation during the 1950's raised the limits on the size of loans and in 1959 the Board's functions were further expanded and taken over by a new Crown Corporation, the Farm Credit Corporation. This body paid out over $78 million on 6,453 loans in the year ending in March 1963, at which time it had loans of $278 million outstanding, nearly all secured by first mortgages on farm property. An increasing share of loans is made to finance purchases of farm land, smaller amounts being lent for the repayment of existing mortgage debts, for farm improvements and for purchases of livestock and equipment. The maximum loan is now $20,000 with special provision for supervised loans up to $27,500 for farmers between the ages of 21 and 45. Amendments to the Act passed in 1962 broadened the field of lending beyond mortgages on farm land by including some types of farming enterprises in which land is not the major capital investment, such as poultry and livestock operations, and by permitting chattel mortgages.

The federal government also lent substantial amounts to farmers for some years after the war under the Veterans' Land Administration, which from 1944 to 1951 was probably the most important single source of farm credit. Amendments to the Act raised the loan maximum in 1960 and

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[18] Statistical information on farm credit is not comprehensive. The figures quoted are from tabulations by R. S. Rust in the *Economic Annalist* (Dept. of Agriculture, Ottawa) for February 1963, and include some estimates.

resulted in increased lending, but with the passage of time, lending under the V.L.A. will come to an end. A more recent intervention by the federal government came in 1961 when the I.D.B. was empowered to lend to farmers: by September 1963, 298 loans to farm enterprises and associated businesses totalling $9.3 million had been approved. The average size of loan was $31,000 and most of the lending to individual farmers was to finance major equipment purchases or farm improvements rather than land acquisition. The rapid growth of such I.D.B. lending suggests that the Bank is meeting a real need for this type of substantial farm finance.

The rate on Farm Credit Corporation first mortgages is 5%. The original 6½% charged by the Farm Loan Board in 1929 was reduced in steps to 4½% in 1945 and then raised to the present 5% in 1952. The earlier rate bore a reasonable relationship to comparable market yields—in 1945 and 1952 the rate was set about 1½% above the yield on long-term Government of Canada bonds—but the current charge is well below them and involves an undoubted element of subsidy which inhibits private long-term farm lending. We note that in 1962-63 the Corporation reported an operating loss of more than $1 million and that it is lending at rates below that paid by the federal government for long-term funds.[19] A comparable private corporation also paying income taxes and having an assumed equity equal to 10% of liabilities would have had to earn about $4 million more before taxes, or approximately 7% on its mortgages, to earn a profit of 8% on its equity. Even if the F.C.C. did not have to meet such stringent profitability tests, but were merely charged with earning 1% after taxes on government money invested in it, its lending rate would still need to be in excess of 6½%.

[19] In 1960 the Corporation earned a profit of $240,020, but since then increases in the cost of its funds and administrative expenses have led to operating losses of $202,798 in 1961, $776,117 in 1962 and $1,080,597 in 1963. The Corporation's borrowings from the government, usually in the form of 10 to 25 year maturities in annual instalments, carry rates ⅛ of 1% above those on comparable issues of direct government bonds and are determined quarterly by the Minister of Finance.

While there are admittedly farm needs for which the government wishes to provide special assistance, as a general rule we believe that efficiency in both agriculture and the financial system is fostered by the normal play of market forces. We recommend therefore that the present statutory method of setting the rate be changed and that the F.C.C.'s rates and charges be set automatically each year in somewhat closer relationship with market rates, perhaps 1¼% to 1½% above long-term Canada bond yields. In our view, any assistance to farm borrowers should be explicit and not the result of inadvertence, and should be given in ways which do not discourage reasonably efficient private lenders from broadening their credit services to meet changing farm requirements. If it is thought desirable to make farm mortgage credit available more cheaply than market forces dictate, the government should subsidize it openly.

The limits of $20,000 on ordinary F.C.C. mortgages or $27,500 to younger, experienced farmers are too low to enable the Corporation to meet the needs of many of the larger, efficient farm units which are playing an increasingly important role in Canadian agriculture. We therefore recommend that the limits be raised and maintained at a level more in line with the value of farm properties. At the present time a limit of $40,000 would be appropriate, and the government should be prepared to raise it further if circumstances warrant it, while maintaining the lending rate at levels which do not preclude the development of private mortgage lending to farms of all sizes. Representatives of the Canadian Federation of Agriculture suggested to us that farmers find it difficult to finance construction of additional housing, for instance as accommodation for hired help, because the F.C.C. normally takes a mortgage on the entire farm property and is often not prepared to finance such a building separately. N.H.A. loans on farm housing also call for a mortgage on the complete farm property and can therefore not be obtained in addition to F.C.C. credit. It is our understanding that the F.C.C. is in fact frequently willing to finance housing so long as its use is connected to the

operation of the farm, and we believe that the Corporation should continue to adopt a flexible approach in this regard. Given higher loan limits, it should be able to meet all reasonable demands for farm housing finance.

Most provincial governments also have agencies to assist farm financing. They usually are intended to supplement the F.C.C.'s facilities by concentrating on special financial needs. For instance, some provinces devote their resources to assisting young farmers to establish themselves, and British Columbia lends only for land clearing. The F.C.C. stated in its 1962 Report to the Minister of Agriculture that steps are being undertaken to provide closer co-ordination with provincial operations and eliminate duplication. Quebec has the most extensive loan service for farmers. Its rate, 2½%, has been very favourable, and until recently few Quebec farmers have sought term credit from other sources: at March 31, 1961 the Quebec government had loans of $118 million outstanding compared to only $7 million lent in the province by the F.C.C. However, in 1962 the Quebec government passed legislation under which farmers can obtain rebates of higher interest paid to certain other lenders, including the F.C.C., so that direct lending by Quebec has fallen and F.C.C.'s activities in that province have increased rapidly.

In addition to its direct lending activities, the federal government guarantees private lending to farmers. The Farm Improvement Loans Act was passed in 1944 to induce freer chartered bank farm lending on a term basis for the purchase of equipment and livestock and for the construction or repair of farm buildings. This Act, and the companion clauses of section 88 of the Bank Act, enable chartered banks to take the relevant equipment or other goods as security for the loan. Each bank's losses up to 10% of its total Farm Improvement Loans are guaranteed, subject to a maximum amount of $400 million outstanding for all banks at any one time.[20] (This procedure of guaranteeing part of each bank's loans subject to an overall limit had been introduced in the Home Improvement Loans Act in 1937, and has subsequently been used in other guarantee legislation.) The maximum loan, which was originally $3,000, has been raised in three steps to $7,500. Loans are made for terms of up to 10 years, (except that equipment loans must be repaid within 4 years) but shorter terms, varying upwards from 18 months for loans of $500 or less, are suggested in the Act's regulations for loans below the maximum. Most loans are made to finance purchases of equipment, with building construction or repair and livestock purchases ranking next.

In September 1963, the banks had $247 million of Farm Improvement Loans and $379 million of other loans to farmers on their books. Total farm lending represented 6.4% of all loans and investments (other than call and short loans and government of Canada securities) compared to 4.3% in 1945 and 6.4% in 1950.[21] The expansion of farm lending by the banks has varied with the demand for funds and has also been affected to a limited extent by changes in bank lending policy resulting from monetary policy. However, the banks have been careful to protect their farm customers along with other small borrowers in periods of tight money and we did not receive representations that agriculture suffers particularly under tight money. The same is true of lending by the F.C.C. which, for instance, expanded rapidly in 1956-57 and again in 1959.

The lending rate has remained at 5% since the Farm Improvement Loans Act was first put in operation eighteen years ago. The initial rate, although by no means high, was originally ½ of 1% above the chartered banks' prime lending rate. In the intervening years, prime rate has risen along with the whole structure of rates and the F.I.L.A. rate is now well below an appropriate level in relation to the cost of comparable credit to other borrowers. The same is true of lending rates under other guarantee programs, which have also been frozen while market rates

[20] The maximum amount of guaranteed loans has been raised from its original level of $250 million.

[21] Loans to grain dealers of $265 million are excluded from the farm lending totals. See Table 7-3.

have adjusted to changing circumstances.[22] At present levels they give no inducement for banks to lend freely to farmers and the other classes of borrower they are intended to favour.

It is our view that government guarantees need not become permanent features of the financial system. Their main purpose should be to introduce private lenders to types of business which they hesitate to enter without some such encouragement. Once the lenders become familiar with the new lending and its risks—which have not been large in the case of nearly all guaranteed lending—the guarantee has served its main purpose and might well be withdrawn.

We do not believe that the banks would reduce their lending to farmers, small businesses and others if guarantees were withdrawn from established classes of business, provided that the Bank Act were amended to permit them to take the mortgage security now available to them under the various guarantee laws. If the general mortgage prohibition were removed and the banks were permitted to lend at appropriate market rates of interest, which would at times exceed the present 6% limit, they might well be prepared to lend more freely than at the present uneconomic 5% rate. However, others may feel that at least for an interim period guarantees should be available to assist special classes of borrower. In that case the rates should be set at perhaps ½ of 1% above the banks' prime lending rate and vary with it. If experience under this system were to indicate that funds would be available without the guarantee, it might then be removed.

The maximum amount of a farm improvement loan was raised to $7,500 in 1959. In view of the increasing costs of equipment and improvements required by efficient farm units, this limit should be raised to $10,000 if the guarantee legislation remains in force. Some adjustment might also be made in the regulations covering down payments. For instance, down payments of 33⅓% and 40% are required on purchases of new and used trucks respectively and the borrower must put up 25% of the cost of permanent improvements such as electrical equipment. It might be advisable to lower some of these amounts, although down payments on loans for building construction and improvement could continue to be 10%. Bank managers might, of course, continue to call for higher down payments when in their judgment they are necessary. Finally, it should be possible to allow some flexibility in the repayment period for equipment loans, which is now limited to 4 years: the limit might be raised to 6 years, although once again individual managers would exercise their own judgment as to the useful life of each farmer's equipment and would frequently set shorter repayment schedules.

Under any approach to government guarantees, and particularly if government policy is directed to encouraging improved private lending facilities, it is clearly desirable that guaranteed loans be made available through as broad a group of institutions as possible. The guarantee of Fisheries Improvement Loans is available to credit unions, but other guarantees apply only to the chartered banks. We see no reason why other institutions with suitable facilities should not be able to apply for any guarantee extended by the government if it would enable them to serve their customers better. The government should not extend it to all institutions of a particular class but limit it to those having the staff, volume of business and experience to administer guaranteed lending soundly. Used in this way, government guarantees can assist in the development of the financial system and, for relatively short periods, can supplement the regular private sources of credit. However, the best way to ensure that gaps calling for such special measures do not persist is to see that private institutions are not discouraged by legislation or government lending activities from meeting new credit demands without recourse to guarantees.

EXPORT FINANCE

The financing of export sales raises some problems not encountered in domestic trade and Can-

[22] The rate on Fisheries Improvement Loans, for example, of which the total outstanding amount is under $500,000, is also 5%.

ada, like other countries, has facilities adapted to the special needs of exporters. Those who sell abroad on delayed payment terms incur not only ordinary commercial risks but also the hazard that buyers will fail to meet their obligations because of war, changes in foreign exchange regulations and import quotas, or other political events. Because of these "political" risks and because the buyer's trade credit is more difficult to assess when he is in another country, many firms would be hesitant to develop export business if they could not obtain protection against its added uncertainty. In Canada, the Export Credits Insurance Corporation (E.C.I.C.) was established in 1944 to fill this need by provision of federal guarantees.

E.C.I.C. sells insurance covering 85% of losses resulting from commercial or political risks—the two are not insured separately as in some other countries—while the exporter himself carries the remaining risk. Its policies cover insolvency of the buyer or his failure to pay within twelve months of the due date as well as the political risks, but not losses owing to such occurrences as a buyer's refusal to accept goods because he considers them unsatisfactory. The Corporation does not provide insurance on sales to the United States because it can be obtained from private sources.

Two main types of policy are available. Sales of consumer goods and other exports made on short-term credit may be insured under general commodities policies, which are annual policies setting a limit on the amount of insured sales. An exporter wishing insurance must obtain and pay for coverage of all sales to all countries to which he ships (other than the United States) and is not able to select particular sales or countries for insurance. This rule is imposed in order to spread the risks of insurance so that reasonable premiums may be charged on exports to any country, and also to avoid the political problem of disclosing higher rates for some countries than for others. Under the second type of policy, sales of capital goods or of engineering and other services on terms extending to a maximum of five years may be insured. Unlike the general commodities policies, these policies are written to cover individual transactions. Premiums on both types of policy are set at levels just sufficient to cover E.C.I.C.'s losses and other expenses, which include income tax.

We received suggestions that the E.C.I.C. should not be required to pay taxes, and the President of the Corporation supported them. At the same time he pointed out that the Government obtains no return on the capital and surplus, which amounted to $12.4 million in 1962, and that "the government can argue that the income tax which is levied against us is a small return on the capital made available for our backing".[23] We have no strong views on this matter, which is in any event part of the broader question of taxation of all Crown Corporations to which the Royal Commission on Taxation will no doubt address itself.

E.C.I.C. is authorized to accept insurance liabilities up to a maximum of $200 million on its own account, and at the end of 1962 had a liability of $71.8 million. It may also write a further $400 million of insurance for which the Government accepts the risk, covering transactions of a size or for a term which the Corporation would not normally underwrite but which the Minister of Trade and Commerce considers to be in the national interest.

A good deal of export trade is not insured with E.C.I.C. because it is going to the United States, because it is covered by irrevocable letters of credit which obviate the need for insurance or simply because the exporter does not think he needs insurance or his bank does not require it. The Corporation estimates that it now insures between 30% and 50% of eligible business, the $146 million of insurance written in 1962 representing about 2% of all exports.[24]

There are a number of detailed differences between the insurance coverage available to Canadian exporters and facilities in other countries, but the broad pattern is similar. "Insurance competition" among exporting countries is limited by the Berne Union of insurance agencies to

[23] Transcript, page 4594.
[24] Transcript, pages 4571-72.

which Canada and the other principal exporting nations belong. Minor modifications might be made with advantage: for instance the Canadian Exporters' Association recommended that the definition of capital goods eligible for insurance up to five years be broadened and that the Corporation should be more willing to write selective policies covering short-term credit to particular countries. These are technical matters on which we cannot make firm recommendations. More generally, we agree with the policy followed by E.C.I.C. of ensuring that Canadian exporters are not placed at a competitive disadvantage owing to inadequate insurance facilities rather than attempting to provide particular advantages for our exporters which would quickly lead to comparable action in other countries and thus produce no lasting advantage. The limits on the Corporation's insurance liabilities have been raised and, although lower in relation to our trade than in some other countries, seem adequate and can be raised again if necessary.

Short-term export credit is available without difficulty from the chartered banks, and they are also prepared to finance medium-term export payments over periods up to five years with the backing of E.C.I.C. insurance. It was thought that the banks were somewhat reluctant to lend as freely as they might for terms over one year, particularly in periods of credit restraint when they are concerned about the liquidity of their assets, and to meet this problem the Export Finance Corporation was set up in 1959 to rediscount medium-term export loans covered by E.C.I.C. insurance. The banks acquired its charter in 1961 following suggestions by the Government that additional facilities were necessary, but the demand for its rediscounting facilities has been limited. On April 30, 1963, the Corporation had advances of $93 million on its books, most of this to finance grain shipments to Europe for terms up to 3 years, with the remainder being largely capital goods sales to Latin American countries.[25] The relatively slow growth of business, despite the fact that its rates are competitive and its returns are intentionally modest—under 4% of captial and surplus in 1963—suggests that requirements for medium-term finance are being adequately met through the normal channels. The corporation obtains most of its funds by selling notes in the New York and—to a lesser extent—Canadian short-term markets.

Private lenders are less willing to give credit to exporters for periods longer than 5 years, and the government stepped into this gap in 1961 by authorizing E.C.I.C., on the approval of the Governor-in-Council, to provide long-term credit as well as insurance for capital goods sales up to a total of $300 million. After two years of operations, 8 loans with a total value of $57 million had been made. These facilities are designed to match those available to exporters in other countries through agencies such as the American Export-Import Bank so that Canadian firms will not be at a disadvantage in competing for large capital contracts in which extended credit terms are often essential to the buyer. E.C.I.C. stated that it does not intend to exceed credit terms elsewhere.[26] The lending program began too recently for its results to be evident, although it is already clear that there can be real problems in applying commercial lending principles in an area which must in the nature of the case involve foreign aid as well as foreign trade considerations.

Some exporters are bound to encounter financing difficulties, but we believe that the facilities available for commercial export insurance and finance in Canada are generally adequate, a view supported by the Exporters' Association whose main criticisms dealt with technical matters or questions involving government subsidization of long-term capital exports to less developed countries.

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[25] A number of major grain sales have been financed in other ways.

[26] Transcript, pages 4575-76.

CHAPTER 13

INSURANCE AND INVESTMENT COMPANIES AND PENSION FUNDS

Previous chapters have been mainly concerned with institutions which deal primarily in short and medium-term funds, although some of these institutions, notably the loan and trust companies, also issue long-term liabilities and invest a large part of their resources in long-term assets. Indeed, few institutions restrict themselves narrowly to assets and liabilities of a particular maturity any more than they deal exclusively with one type of customer, and classifications are therefore bound to be somewhat arbitrary. Nevertheless, the institutions which we will now discuss—insurance companies, pension funds and investment companies—are essentially long-term financial intermediaries in both their borrowing and their lending activities.

The manner in which these intermediaries collect most of their funds from savers is one factor which sets them apart. Other institutions sell most of their liabilities in exchange for single payments: for instance, the purchaser of a loan company debenture makes that one investment without committing himself to further investments in the loan company's liabilities. On the other hand, life insurance companies, pension administrators and, to a lesser extent, investment companies collect a large part of their funds on the basis of contracts involving a series of payments stretching into the future. People enter into such contracts in order to obtain the protection of life insurance or annuities and because they find it a convenient way of accumulating savings over the years. These particular financial assets are normally regarded by their holders as a final reserve to be liquidated for current spending only as a last resort: indeed many pension fund contributions cannot be withdrawn at all until retirement. Since these long-term savings are not generally subject to sudden withdrawal, the institutions administering them may safely invest a high proportion of their pools of funds in long-term assets and need retain only a modest liquidity position to meet claims, cancellations or withdrawal of funds. Mutual funds do not fit this pattern entirely; although much of their business involves contracts for payments into the fund over a number of years, the saver is free to redeem his shares at any time and may do so without sacrificing the protection which is the prime consideration in an insurance contract. However, redemption may be costly, and in any case people usually buy mutual fund shares with the intention of holding them as part of their long-term savings.

There has been an increasing amount of competition among insurance companies, pension administrators—including trust companies—and mutual funds as they have attempted to devise new contracts to attract long-term savings. Prior to the Second World War, the life insurance companies were virtually alone in the field except for the Annuities Branch of the federal Department of Labour. During the past fifteen years an increasing share of the population has entered pension plans and at the end of 1962 trusteed pension plans held assets of $4.6 billion: this compared to total assets—representing both life insurance and annuity funds—of almost $10 billion held in Canada by life insurance companies and fraternal societies. At the same time the establishment of

many investment companies has provided a third main institutional outlet for long-term savings. Both mutual funds and closed-end companies offer savers a share in a balanced portfolio of investments, and the former permit convenient investment by regular payments. The mutual funds which specialize in equity investments also offer the prospect of capital gains. The possibility of sharing in the growth of the economy and hedging against the danger of inflation has attracted many investors and contributed much to the funds' rapid growth. Buyers have not apparently been greatly deterred by the bigger risk of loss entailed in diverting funds from fixed-dollar claims to equities.

Savings through life insurance, pension contributions and investment companies are favoured by special tax arrangements. A 2% tax is collected on premiums, but life companies pay no tax on their income, except on the relatively small amounts allocated to shareholders. Pension contributions up to specified limits may be deducted from taxable income[1] and the investment income accruing to the pension fund is tax-free, although pension receipts are taxable. Finally, domestic investment companies are entitled to a special tax rate of 21% of taxable income if their investments and sources of revenue meet certain tests which will be described later in this chapter. Some are unincorporated and trusteed and pay no taxes themselves, the income passing directly to the participants.

The tax arrangements undoubtedly offer some inducement to invest through these institutions, particularly in the case of pensions. However, the funds they collect are the basic element in most people's savings and provide them in a convenient way with the protection which they feel they need. Since only a relatively small minority of people have the resources and skills to arrange for savings and protection in other ways, it is probable that these tax features have only a marginal effect on the amount and allocation of savings in the economy. Such effects, however, doubtless favour the institutions concerned at the expense of individual investment, and probably of some shorter-term institutions as well.

[1] Members of pension plans may deduct contributions to the plan and payments to other registered retirement savings plans amounting to the lesser of $1,500 or 10% of earned income. Their employers may contribute an additional $1,500. For those who are not members of company plans (and for whom contributions are not, therefore, being made by their employers) the limits are $2,500 or 10% of income.

—	Life insurance companies[a] (assets in Canada)	Trusteed pension Plans[b]	Canadian Mutual Funds[c]
Year end, book value of assets ($ millions)			
1945	3,125	n.a.	n.a.
1950	4,304	875	42
1955	6,043	1,835	191
1962	9,950	4,572	710
Annual rates of growth			
1945 to 1950	6.6%	n.a.	n.a.
1950 to 1955	7.0%	16.0%	35.4%
1955 to 1962	7.4%	13.9%	24.5%

[a] Assets held against life insurance and annuity contracts by insurance companies and societies.
[b] Method of estimating data for 1950 and 1955 is the same as that described later in the chapter.
[c] Mutual fund data are for 1951, 1956 and 1962, covering members of the Canadian Mutual Funds Association.

THE LIFE INSURANCE INDUSTRY

Canadians are in fact very well insured compared to people in other countries, with an average of over $11,000 in force per household. Total life insurance in force is about twice personal disposable income and annual premium payments absorb 3% of disposable income. Saving through life insurance companies on insurance and annuity business, which includes the companies' net investment earnings as well as premium receipts and is net of claims paid out by the companies, accounts for more than 25% of net personal saving.

The Canadian life insurance industry includes 105 federally registered companies[2] which in 1961 had 92.4% of the assets, 23 provincial companies with 3.3% and about 75 fraternal benefit societies with 4.3%. Although some of them are

[2] Six of these companies no longer write new business in Canada.

sizable institutions, the business done by provincial companies and fraternal benefit societies is thus small relative to the federal companies. The largest fraternal benefit society had assets of $113 million in 1962, while the largest provincial company had assets of about $100 million. These two institutions are larger than all but 16 of the federal companies, but most of the fraternal societies and provincial companies are small institutions doing a regional business. Apart from the fact that fraternal societies deal only with members of their own group, these institutions and the provincial companies conduct a business similar to federal companies and discussion in this chapter will concentrate on the latter group.

More than 90% of the assets of federal companies are held by 16 companies having assets of $100 million or more, 12 of them being Canadian, 2 British and 2 American.[3] The number of federal companies has risen from 65 in 1950 to 105 at present, all but 6 of the new companies being either British or foreign. As a result of the entry of these new companies and the rapid growth of some of them, the share of business held by the big companies has declined somewhat. Moreover, there have been marked differences in the growth rates of the larger companies, a number of which have a considerably smaller share of the business than they did a generation ago.

The Canadian insurance industry is more international than most sectors of our financial system. Many of the 36 Canadian federal companies, 13 of which are in fact now controlled outside Canada, do a substantial business abroad, particularly in the United States and the United Kingdom. At the end of 1962, the Canadian companies had total assets of $9.8 billion, of which about one-third related to their foreign business. At the same time, foreign companies operate in Canada: 16 British companies had assets of $624 million in Canada and 53 other foreign companies, most of them from the United States, had assets of $1,800 million here. Many of the foreign companies are small, some of them writing nominal amounts of Canadian insurance and being registered mainly for the investment of surplus funds arising from operations elsewhere.

Its international character brings increased competition and new techniques to the Canadian insurance market. In view of this competition, we are inclined to question the prohibition in the Canadian and British Insurance Companies Act against one life company investing in the shares of another. This prohibition, similar to that precluding banks from investing in other banks, was introduced in 1910 at the request of the insurance companies themselves.[4] However, no similar prohibition applies to foreign companies and control of a number of companies has been acquired by foreign interests in recent years. In order to protect Canadian companies

[3] These data refer to the domicile of the companies, not to their ownership.

[4] Transcript, page 6788.

TABLE 13–1

LIFE INSURANCE ASSETS IN CANADA[a]

($ millions)

	1935	1945	1950	1955	1961	1962
Federal companies	1,828	2,886	3,997	5,599	8,574	9,183
Provincial companies	28	54	84	162	307	767[c]
Fraternal benefit societies	135	185	223	282	400	
TOTAL:	1,991	3,125	4,304	6,043	9,281	9,950[c]

[a] All federally-registered companies; provincial companies and fraternal benefit societies registered for business in Quebec or Ontario. A small amount of assets held by Companies and societies in other provinces is not included.

[c] Estimated.

against takeovers, the law was changed in 1957 to permit a joint-stock company to acquire its own shares and thus become a mutual company. There are now 11 federal mutual companies and 2 more are in the process of becoming mutual. The Superintendent of Insurance made the point that a Canadian company buying another would almost certainly merge the two operations and thus reduce the number of companies competing for insurance business, while foreign interests would continue to operate the original company in Canada.[5]

In view of the large number of companies operating in Canada and the fact that 13 of them having about 65% of the business are or will shortly be mutual companies, we see no reason why Canadian companies should not be free to acquire others, provided that the Minister of Finance approves of the purchase as being in the public interest, a procedure suggested by the life insurance companies.[6] It may well be true, as the Superintendent suggested,[7] that foreign interests will be willing to pay more for a company in order to acquire the established organization which another Canadian company would not need, but Canadian companies should not be precluded from bidding regardless of the circumstances. We do not agree with the Superintendent of Insurance that since policyholders have chosen to do business with a particular company its separate existence must necessarily be preserved.[8] If the new company is better managed than the old, they can expect to benefit from more efficient investment of the funds, and the efficiency of the life insurance industry as a whole will be raised. Removal of the prohibition would also enable the companies to form subsidiaries for their operations in foreign countries, and we see no reason why this should be prevented.

[5] Transcript, pages 6799-6800. A Canadian company may amalgamate with another by taking over its assets and liabilities, subject to Treasury Board approval; a Canadian stock company has taken over a mutual company in this way.

[6] Transcript, page 2381.

[7] Transcript, pages 6789-90.

[8] Transcript, pages 6801-2.

LIFE COMPANIES AS COLLECTORS OF SAVINGS

Life insurance companies offer protection and a means of accumulating savings. Whether it be life insurance or annuity coverage, the element of protection is the essential feature of every policy. The savings element, on the other hand, varies widely with the type of policy sold. The holder of a term policy buys protection only: if he dies, his beneficiaries obtain the insurance, but during his lifetime he does not accumulate any savings. In many other insurance policies, however, and in all annuity contracts, larger payments which are usually made over a number of years provide for the accumulation of substantial savings as well as covering the cost of protection itself. So long as premiums are set appropriately in relation to the life expectancy of policyholders and the companies' earnings, the companies will obtain premium and investment income in excess of current claims and will thus have substantial pools of long-term funds available for investment.

Since this type of savings is combined with the purchase of protection, the rate of return offered on savings need not be as high as would otherwise be needed to attract funds. The companies compete actively with each other in terms of all the features of their policies: the insurance benefits, which may include health coverage as well as any number of variations on the basic insurance or annuity provisions; the premiums charged, which can be reduced if earnings obtained on investments are increased; contractual rates of interest written into the policies and, in participating policies, the prospect of sharing in the companies' income. The rate of return on savings has its important place within the competitive package, but often does not have priority in the purchaser's thinking. Since the contracts are often complicated and each individual has particular requirements, the life companies obtain business through personal sales forces, normally paid on a commission system, rather than over the counter in branch offices.

Despite the unique characteristics of life insurance, the companies must compete actively for the public's savings. The spread of pension plans and government retirement assistance has meant that many people have less need to accumulate savings through life insurance. A growing interest in equity investments through mutual funds has also contributed to a rapid increase in sales of term insurance rather than policies with a savings element. A high proportion of term insurance is sold to groups, often in conjunction with pension plans. In 1961, 18% of the federal companies' insurance premiums came from group business, compared to 5% in 1945, and the share of group policies in total insurance in force had risen to 33% from 11%. The insurance companies have competed directly for the pension business through their annuity policies: these have grown from less than $100 million in force in 1945 to $866 million in 1962.[9] Thus the reduction in the flow of funds into the life insurance pool resulting from the slower growth of insurance policies with a high savings content has been in part offset by the growth of annuity business which produces a substantial flow of funds to the companies.

The pressure of competition within the industry and from other sources has also led to greater concentration on the rates of return paid on savings and to a variety of dividend arrangements, including policies in which future benefits vary with dividend rates. Competition from the mutual funds led—at the insurance companies' request—to a change in the law in 1961 to permit the writing of "variable annuity" policies in which benefits vary with earnings on a specific group of segregated assets. The industry has apparently not pressed the sale of these policies and at the end of 1962 the seven companies reporting them had segregated assets of $5 million of which only 19% was in corporate stocks. This competition for funds is bringing the insurance companies to lay more stress on the advantages they offer the individual as managers of funds, to devise new combinations of protection and savings features and to improve the calibre of their sales forces in order to attract business. It has also caused them to become increasingly alert to opportunities to increase their earnings and reduce costs in order to offer more attractive contracts to the public.

The result of this process has been to reduce the cost of insurance and to increase the rate of return on savings through life insurance companies. Also important have been the shift towards a higher proportion of term insurance, improved mortality experience, and higher investment earnings. In the event, premiums are now equal to 1.55% of insurance in force compared to 2.35% in 1950. Both the pool of life insurance assets and premium income have grown more slowly with the shift to term insurance, premium income remaining quite stable in relation to life company assets. On the other hand, investment income has risen with the general level of interest rates and at just over 5% of assets is close to that of the trust companies although more than 1% below that of the loan companies. Administrative expenses, which are relatively high owing to the costs of commission sales, were about 3½% of assets in 1961 and have risen a little over the years. Investment costs account for .34% of assets.[10]

Because of higher investment revenue, only a small part of which has been absorbed by higher administrative and investment costs, the return on life insurance savings has been increasing. Unfortunately the rate of return cannot be derived from the published statements but we know that premiums have been reduced and that dividends on participating policies, which were only 7% of the revenue of Canadian companies in 1950, are now 9%. Little of the increase in investment income has gone to shareholders' accounts. Because of the very limited share capital and conservative dividend policy, dividends to shareholders are equal to only .04% of assets and under ¼ of 1% of revenues, while surplus accu-

[9] These are the amounts of contractual annual commitments, a large part being payments to be made in the future under contracts which had not yet matured.

[10] These data relate to federally-registered Canadian companies. Investment costs are those for a smaller number of companies—see Table 5e of C.L.I.O.A. Submission.

mulation accounts for somewhat less than half as much as dividends actually paid out to policyholders. Despite these improvements, the return on savings in life insurance is still relatively low because, as representatives of the industry told us, the collection of savings through life insurance is an expensive business—although commission costs are lower in Canada than in the United States.[11] Nevertheless, savers are prepared to accept relatively low, although improving, returns because of their need for insurance protection.

INSURANCE COMPANY INVESTMENTS

The investment policies of life insurance companies are closely related to the character of their liabilities. Because of the contractual nature of their borrowing, they are able to predict reasonably accurately the flow of new funds which, together with the proceeds of maturing assets, will be available for investment. These forecasts cannot be precise; claims under insurance policies may differ from those expected on the basis of the mortality tables used; sales of new policies cannot be exactly predicted since they will depend on levels of personal income, on the efforts of the companies' agents and on competition with other forms of long-term savings; customers may surrender their policies or borrow against them; and losses may have to be absorbed on some investments. Even after taking account of these factors, an established life insurance company can foresee its position reasonably accurately and can count on a net cash inflow for some years ahead resulting from the business already on its books. Its position is thus quite different from that of an institution issuing "single-pay" liabilities, and particularly from one which borrows on a demand basis. An insurance company need not be concerned about the liquidity of its assets to nearly the same extent as an institution which cannot count on an inflow of funds from contracts already written and which may have to sell part of its portfolio at any time to meet unexpected demands from holders of its liabilities or borrowers. Life companies may therefore safely invest largely in long-term assets.

The many treatises written on the guiding principles of life insurance company investment also stress the need for maximum security. Although they are not usually subject to sudden unexpected calls on their funds, there must be no question of the companies' ability to meet their contractual obligations. The soundness of their investments is also an important factor in attracting new business.

(i) *Regulation*

Canadian insurance company legislation seeks to protect the policy holders by restricting investment to certain types of asset and by subjecting the companies to thorough government supervision. Federal companies may invest in Canadian federal and provincial government direct and guaranteed securities and similar issues of the United States, the United Kingdom and Commonwealth countries; they may also buy Canadian municipal securities, corporate bonds fully secured by mortgage and other bonds of corporations which have paid specified minimum dividends on their stock or have met minimum earnings requirements in relation to interest charges for at least five years. In addition, they may invest in real estate mortgages, (but may not lend more than two-thirds of the property value unless the excess is guaranteed by a government) and in specified income-producing real-estate or leaseholds up to 10% of assets. Preferred stock may be purchased if the company meets the 5-year dividend requirement applicable to investment in bonds. However, investment in common stock is subject to a 7-year dividend test, to not more than 30% of a company's stock being acquired, and to the total book value of common stock held not exceeding 15% of a life company's assets. The companies may also lend on the security of any of these assets or on the security of life insurance policies. Finally, they may invest 5% of their funds in assets not meeting the normal quality requirements although this "basket" provision may not be used to acquire mortgages over two-thirds of

[11] Transcript, pages 2444-5.

property value, to exceed the 30% rule regarding investment in any one company, to acquire stocks or income-producing real estate in excess of the 15% and 10% limits or to evade the prohibition against loans to directors and the companies of which they are directors.

These investment powers have been broadened somewhat in recent years—in 1961 the mortgage loan to value limit was increased from 60% to 66⅔%, the "basket" clause raised from 3% to 5% of assets and the restriction on income-producing real estate lifted from 5% to 10%. At the same time, provision was made for "segregated" investments not subject to the limitations on equity and real estate investment to be held against variable benefit annuity policies. These amendments gave the companies more freedom in their investment policies, but the acts are still intended to restrict the investment of insurance company funds, particularly with respect to common stock. It should be noted that the insurance company investment restrictions, which have been developed and amended over the years, contain some rather anomalous provisions. For instance, mortgage lending is restricted by the 66⅔% of value limit, but the companies are free to buy corporate mortgage bonds without limit. Similarly a sale and leaseback arrangement may be used instead of mortgage finance, without a limit as to the individual amounts advanced in this way.

The Superintendent of Insurance examines each company annually to see that its investments meet the requirements of the law and has the power to establish the value of all investments in their statements; the manner in which policy liabilities are to be computed is also subject to his approval. The legislation, and the Superintendent's authority under it, have undoubtedly contributed to the conservative investment policies—in many cases more conservative than the law actually requires—which are typical of the industry.

(ii) *Portfolio Composition and Changes*

At the end of the Second World War, 77% of the federal life companies' Canadian funds were invested in bonds, while only 10% were in mortgages.[12] Government of Canada securities alone accounted for about 60% of assets, but in succeeding years the companies liquidated a substantial part of these holdings and invested the proceeds, and new funds, in other assets offering higher returns, principally mortgages and corporate bonds. In 1962, almost 40% of their funds were in mortgages and 22% in corporate bonds; holdings of federal securities, although higher than the low point reached in 1957, accounted for only 7% of assets. Corporate stock holdings were $274 million or just 3% of assets, a proportion which has remained quite steady through the post-war period.

Because of their size, the insurance companies are a major factor in each of the markets in which they invest at all heavily. Although the trust and loan companies have gained on them in recent years, they are still by a considerable margin the principal buyers of mortgages: at the end of 1962 the federal companies' holdings of $3,639 million were 40% of all mortgages held by financial institutions, government agencies and corporate lenders. Similarly they are the largest group of investors in Canadian corporate bonds, of which they held 26% at the end of 1962, and are a powerful force in the municipal and provincial markets, having 16% and 13% respectively of the net amounts of these government debts outstanding. The reduction of their Government of Canada portfolios has brought their holdings down to 6% of market debt outside official accounts. Though more important than the chartered banks in the market for long bonds, of which they hold 13%, they are of much less importance in the short markets, their holdings being only 2% of outstanding Canada issues maturing within ten years.[13]

The investment policies of the individual companies vary a good deal, with the main decision relating to the share of funds invested in mortgages or in bonds. Mortgage portfolios of the

[12] The Canadian companies had additional assets of $3.2 billion in 1962 relating to their business in other countries, and some of these funds were also invested in Canadian securities. The distribution of assets is shown in Table 13-2.

[13] The maturity distribution of life company portfolios is shown in Table 13-3.

TABLE 13–2

FEDERAL COMPANIES: ASSETS IN CANADA[a]

	1945[a]		1950[a]		1957		1962	
	$ mn	%	$ mn	%	$ mn	%	$ mn	%
Cash	28	1.0	50	1.3	47	0.7	45	0.5
Bonds:								
Govt. of Canada	—	—	—	—	538	8.3	677	7.4
Provincial	—	—	—	—	415	6.4	917	10.0
Municipal	—	—	—	—	427	6.5	651	6.7
Corporate	—	—	—	—	1,749	26.9	2,005	21.8
Foreign	—	—	—	—	128	2.0	131	1.4
TOTAL BONDS	2,222	77.0	2,710	67.8	3,257	50.0	4,345	47.3
Stocks:								
Canadian	101	3.5	131	3.3	139	2.1	220	2.4
Foreign					76	1.2	54	0.6
Mortgages	280	9.7	769	19.3	2,367	36.4	3,639	39.6
Real Estate	36	1.2	58	1.5	223	3.4	311	3.4
Policy Loans	152	5.3	178	4.5	295	4.5	372	4.1
Other Assets[b]	67	2.3	101	2.5	106	1.6	197	2.1
TOTAL	2,886	100.0	3,997	100.0	6,511	100.0	9,183	100.0

[a]Details of the securities portfolio of the industry are not available on a comparable basis prior to 1954. For twelve large companies having about 75% of the business, 59% of assets in 1946 were Government of Canada securities, 6% provincial, 4% municipal and 9% corporate issues.

[b]Includes the unamortized portion of life companies' own stock purchased under mutualization plans.

SOURCE: Superintendent of Insurance for Canada, Bank of Canada and Submission of the C.L.I.O.A.

larger companies vary from 12% to 66% of assets, while their bond holdings range from 80% to 25%. Although most companies have shared in the post-war shift towards mortgages, each one tends to maintain its broad preference for mortgages or bonds through the years, largely because the two types of investment call for different internal organizations and investment skills. Mortgage investing requires a branch organization which takes time to develop and can pay its way only through a relatively steady flow of investment. Securities investment needs a less extensive organization—a small sample of companies reported 1960 investment costs of .09% for funds invested in securities compared to .42% for mortgages[14]—but special skills are still required. The companies which have developed the necessary personnel thus find bonds more attractive in spite of their lower gross yields, especially the smaller companies, which find the costs of establishing a mortgage department prohibitive.

Given their broad investment preferences and organizations, the companies adjust the flow of their investments to the structure of yields available on different classes of mortgages and bonds. Some companies invest very little in N.H.A. mortgages, but the industry as a whole varies its purchases of guaranteed and conventional mortgages with changes in the difference in yields between them. Similarly, the shift out of Government securities and into corporate bonds has resulted from the attraction of higher yields and greater availability of the latter, especially in years of high business investment. Such changes in life company investments are not as dramatic as are, for instance, the portfolio changes which banks undergo, being largely a matter of redirecting the investment of new funds and the proceeds of maturing assets. The amounts in-

[14] Submission of the Canadian Life Insurance Officers' Association, (C.L.I.O.A.) Table 5e.

volved are nevertheless very large, even though they do not bring about sudden changes in the structure of the companies' portfolios.

It is frequently asserted that the life insurance industry's investment policies are not flexible enough, and that some companies rely on rules of thumb and quotas covering different types of asset rather than comparisons of their yields. Industry representatives told us that it is indeed common practice to establish the broad lines of future investment policy in relation to expected cash flows, and even to assign quotas to the main types of investment.[15] It would be extraordinary if this were not done in that the mortgage and security departments can function best if they have at least a general idea of the amounts they can expect to have available. This is particularly true of the former because the companies do not like to disrupt the builders and others who bring them mortgages by following too changeable a policy within a short time. Similar guide lines are frequently applied to the main classes of bonds, and once again they assist in the daily job of managing the entire portfolio.

Where such limits are set down by the directors and senior investment committees, they are not rigid and can readily be changed when attractive investment opportunities arise, but they are not always adjusted promptly to changing circumstances. On occasion, an institution will not make an investment because that quota is filled, even if comparable issues are yielding less. Sometimes this may be no more than a polite way of refusing an issue unwanted for other reasons. Nevertheless, if inflexible or artificial quotas not needed to maintain diversification of risks were to distort the investment pattern, they would be harmful to the company's and policyholders' best interests as well as thwarting the market allocation of funds to the most pressing needs. No doubt this does sometimes happen, and some companies are not always as sensitive as they might be to prices and yields. However, their administrative arrangements, including the use of quotas, do not on balance appear to inhibit their investment freedom excessively.

In this connection, we were told that local representatives of the companies anxious to see that money is invested in their areas for sales reasons encourage the investment departments to take up local municipal and other issues.[16] This sort of pressure helps to ensure that such borrowers are not excluded owing to head office rules of thumb or unfamiliarity with the issues. Indeed, evidence was submitted indicating that the companies do spread their investments across the country rather than favouring borrowers who happen to be near their head offices. The calculation provided by the industry, which necessarily involves some estimation, shows differences among provinces in the relationship of investments to policyholder liabilities but does not suggest that there is any discrimination in favour of the central parts of the country.[17]

Changes in financial policy and interest rate levels do not significantly affect the rate of growth of their assets, and the companies therefore do not find themselves in the situation faced by banking institutions when a restrictive policy sharply reduces the flow of funds available for investment. Life companies may have to meet a slightly increased demand for policy loans from borrowers unable to obtain funds elsewhere, and may find that amounts left on deposit by policyholders decline or that surrenders of policies increase, but the effect of these changes on their cash flow is small.

The response of life insurance companies to changes in credit conditions is similar to their response to changes in the relative yields on different assets in that it is largely a matter of adjusting the direction of current investment flows. Given the quite steady growth in their assets through periods of tight and easy money, the companies respond by reaching out for long-term investments when rates are high. Conversely, they allow their portfolios to shorten somewhat, and hold new funds in short-term investments when rates are low and expected to

[15] Transcript, page 2478 ff.

[16] Transcript, page 2556.

[17] Submission of the C.L.I.O.A., Table 5a.

rise. Thus, when rates are high and strong demands make attractive mortgages available, they tend to raise their rates and extend mortgage commitments freely so that the cash flowing out in succeeding months will go into high-yielding assets even if market rates have begun to soften. If, as usually has happened, conventional mortgage rates rise more rapidly than the N.H.A. rate, the flow of funds into guaranteed mortgages will fall relatively. However, some companies doing a substantial N.H.A. business may continue to lend, although in reduced amount, to builders who rely heavily on them and bring them a steady supply of investments.[18]

Given their future commitments, the companies vary their holdings of cash, treasury bills and other short-term assets in the light of their expectations about interest rate levels. Information prepared for us by twelve large companies, however, shows that the amounts involved are not large relative to their cash flows or to the operations of the chartered banks; the sum of their net cash, treasury bill and commercial paper holdings for example, rose only from $21 million in mid-1957 to $67 million a year later when interest rates had declined substantially.[19] Security portfolios are of course heavily concentrated in long-term issues, about three-quarters of the holdings of federal, provincial and corporate bonds now being in issues of 10 years or longer. The only substantial change shown by available statistics in recent years was the move into longer-term Canadian government issues at the time of the Conversion Loan in 1958: since then about 80% of the government portfolio has been in issues of over 10 years. The share of government bonds in under two year maturities has also increased, principally because of the concentration of recent federal financing in this part of the market.

Most of the companies do not carry their response to changes in the level and structure of rates to the point of trading out of lower-yielding into higher-yielding securities. There are a few companies which do trade actively, but the general pattern of industry behaviour is to hold investments until they mature

[18] The mortgage market is more fully discussed in the following chapter.

[19] There is a substantial seasonal swing in these liquid assets associated with the pattern of mortgage lending. See the appendix volume for details.

TABLE 13–3

MATURITY DISTRIBUTION OF SECURITIES[a]

Year-end	2 years and under	Over 2 years to 5 years	Over 5 years to 10 years	Over 10 years	Total
	percent				$ millions
1951—Federal	0.5	2.6	43.0	53.8	893
Provincial	1.1	5.6	25.0	68.3	202
Corporate	1.5	3.2	13.0	82.3	928
1955—Federal	5.4	20.3	39.7	34.6	607
Provincial	3.2	14.2	14.7	67.8	239
Corporate	2.1	4.4	11.7	81.8	1,250
1958—Federal	8.6	3.4	6.4	81.6	454
Provincial	6.3	5.1	23.2	65.4	263
Corporate	2.8	4.6	18.4	74.2	1,506
1961—Federal	11.8	7.0	1.3	79.9	522
Provincial	1.3	4.5	17.5	76.7	572
Corporate	3.0	6.8	22.9	67.3	1,486

[a] Based on a survey of 12 companies (with 75% of net premium income in 1961) carried out by the Canadian Life Insurance Officers Association. Full details will be found in the appendix volume.

or have only a short while to run. The companies which do not trade their portfolios have often not developed the experienced personnel necessary for successful secondary-market operations and would find it difficult to alter their policy. Some believe, moreover, that the potential returns from more active portfolio management do not justify the expense, or that their holdings are too large and contain too many illiquid issues for any substantial part to be turned over advantageously in the market. These are valid and understandable reasons, and we do not wish to suggest that all life companies would necessarily serve their policyholders and the capital market as a whole better by adopting the policy of the few with active trading programs. Nonetheless many companies could usefully trade more actively and we have enquired whether, as has been suggested, the present valuation rules inhibit them from doing so.

(iii) *Valuation and Investment Policies*

Life insurance companies are bound by quite rigid regulations covering the valuation of their liabilities. A fixed present value is set on each policy—or batch of similar policies—by discounting at a particular rate of interest the future premiums and probable future claims as given by mortality tables. This present value is known as the actuarial reserve and must be matched by an equivalent amount of assets to meet the solvency requirements of the insurance legislation which are designed to ensure that the company will be able to meet its obligations. These are highly technical actuarial calculations which we do not need to examine in detail; the important point for the present is that in Canada not only the premiums, but also the mortality table and rate of discount to be used in calculating reserves, are fixed when the policy is sold—the latter two being subject to approval by the Superintendent—so that its value for statement purposes is inflexible.[20] This enables the companies to guarantee specific cash surrender values throughout the life of a policy; it also means, however, that the rate of discount used, which reflects a view of the rate of future earnings on assets which will be available to assist in meeting the liability, may not be altered with the general level of rates.

Since the companies are bound by rigid liability values, any change in the value of their assets arising from changes in market prices and yields will affect the companies' surplus positions. No company wants to report a drop in its surplus—its competitors may point to it as a sign of mismanagement or weakness.[21] Moreover, the complete disappearance of surplus would indicate technical insolvency (although not necessarily meaning that the assets will not recover their value and enable the company to meet all its obligations). Thus, most of the industry has favoured protecting the stability of reported surplus by valuing assets as rigidly as liabilities, that is by extending the use of amortized cost rather than market values. On the other hand, the authorities favour market values, and the present rules applying to Canadian companies are a compromise.

The total value of securities shown in a Canadian company's annual report may not exceed the sum of amortized values of Canadian federal and provincial securities and issues of the U.S. and U.K. governments, plus the market values of other securities. Lower values may be shown, and most companies do in fact carry equities at well below market values, either by retaining the original purchase price if the stock has appreciated, or by writing it down to the degree permitted by the Department of Insurance. Oddly enough, the authorities, who favour the use of market values as being the most realistic measure of assets available to meet obligations, discourage the companies from writing up the values of individual assets whose price has risen. The companies are thus in fact obliged to show unrealistic values for many issues. The compromise rules are, moreover, rather inconsistent: the assets which are most likely to be sold in the market—government securities—are amortized, while

[20] The "segregated fund" policies permitted by the 1961 change in the law referred to earlier are an exception in that the value of these reserves may vary with changes in the value of the assets concerned.

[21] Transcript, page 2462.

others which are seldom if ever sold—and indeed could not be disposed of in any quantities without seriously affecting the market—are shown at quoted market values. British and foreign companies are required to show all assets at market values, writing them up or down as need be, on the grounds that if they were to stop doing business in Canada another company would only take over their assets at the market price. Moreover, the Canadian authorities have no control over the disposition of a British or foreign company's surplus.

These valuation rules may influence investment policies and the companies' willingness to trade securities in the market. Given the rigidity of their liabilities, many companies are less willing than they might be to invest in assets which may not be shown at above market values, since falls in the price of such assets would expose them to the danger of sharp declines in surplus. This has been advanced as one reason why they prefer assets which can be amortized[22] and why they shy away from equities. In this connection, it might be noted that the legislation authorizes the Minister of Finance to establish higher values in order to preserve technical solvency if an otherwise sound company is hard hit by a market drop. Such special values were used during the 1930's but would not be applicable to the more moderate changes in surplus which also concern the companies.

Although this valuation and surplus problem does no doubt act to deter some stock investment, it is hard to believe that it is in itself the explanation of the industry's low equity holdings. Most companies could increase their stock holdings substantially before they reached a size which might seriously endanger the stability of surplus. In any case they may be carried at less than market value by Canadian companies so that a swing in the stock market need not force reported values down unless it is of major proportions. Moreover, some of the companies which do approach the 15% common stock limit are in fact British companies which are required to show both increases and declines in the market values. Company policies may thus be strongly influenced by the rules but need not be determined by them.

So far as trading activity is concerned, some companies appear unwilling to sell an amortized security at less than its value on their books in order to switch into a higher-yielding investment. This is because the book loss must be shown, and will reduce reported surplus unless it can be offset by profits on other transactions. If the security were subject to market valuation, the decline in its price would reduce surplus whether or not a trade actually took place, and it is argued therefore that the companies would feel freer to trade. Indeed, one company which does trade actively favours the use of market values to clear away the book loss problem, which is simply an accounting rigidity, and to focus attention on the real alternative yields open to it at any point in time.

This company and a few others do trade their portfolios as much as the secondary markets permit, in spite of the amortization rules, partly because they have been able to protect their surplus positions by realizing capital gains on some investments while accepting trading losses on others. As with the matter of equity investment, the rules do not prevent a company from trading, although they are undoubtedly an inhibiting factor. Changes will thus not lead to an immediate or drastic alteration of long-standing company policies, but some useful improvements might nevertheless be made.

The principal objective should be to introduce greater flexibility into the methods of valuing liabilities so that they may be adjusted in some degree to the same market forces as affect asset values. Unnecessarily rigid liability valuations should not be allowed to stand in the way of a sound allocation of capital in financial markets. It is undoubtedly true that for the present the popularity of cash surrender value policies prevents any sudden development of the freedom enjoyed by insurance companies in the United

[22] The higher yields available on corporate bonds have been sufficient in most of the post-war period, however, to attract heavy life company investment in spite of the companies' inability to carry them at amortized values.

Kingdom in choosing valuation rates of interest. We do not pretend to have expert knowledge, but we nonetheless think it desirable and possible for the authorities to permit greater flexibility over time in liability valuation and to join with actuaries in the industry in developing new approaches to the task. We have been assured by actuaries with whom we have discussed the problem that while there are difficulties to be overcome they are by no means insuperable. The introduction of flexible reserve rules for the variable annuity business was a useful departure: it should prove possible to develop comparable flexibility in both the design of life insurance policies themselves and methods of valuing them. If it were possible to devise methods which would allow the actuarial value of policies to reflect market forces, the companies could carry their assets at market values, thus applying consistent assumptions to both sides of their balance sheets. Any valuation rules necessarily involve a somewhat arbitrary set of calculations, but such an approach would be more realistic than most, and would not expose the companies to those fluctuations in surplus which appear to be such an embarrassment. There would then be nothing in their bookkeeping to inhibit the Canadian companies from adjusting their investments to market prices and yields; it would also place these companies in the same position as their British and foreign competitors in Canada.

However, progress in developing more flexible liability valuation may well be slow, and in the interim rigidity on that side should be matched by some stability of asset values from year to year in order to preserve the stability of surplus accounts.[23] It would be appropriate, therefore, to continue for the time being to value all government securities other than municipals at or below amortized cost, but we see no need to adopt the industry's suggestion of extending this method of valuation to municipal securities. Nor do we believe it desirable to move towards rigidity in the valuation of stocks by using the three-year averaging method recommended by the industry. However, the companies should be permitted to write up as well as write down asset values within the maximum levels set by the legislation: discouragement of write-ups justified by market developments serves no useful purpose and may at times inhibit desirable portfolio adjustments.

It is worth emphasizing that the soundness of the Canadian insurance industry is based not only on the figures which appear in annual statements but on careful management by the companies and supervision by the Superintendent's Department, both of which enjoy the highest reputation in Canada and abroad. All valuation procedures are arbitrary, but within a reasonable and meaningful framework, the details need not intrude unnecessarily on intelligent asset management by the companies or impede the free flow of savings and capital.

(iv) *Equities*

As we have mentioned, only a few companies have approached the 15% of assets they are permitted to invest in common stock, although some have been restricted by the rule.[24] Some of the British companies, which in the absence of restriction are accustomed to investing heavily in stocks in the United Kingdom,[25] are well above the Canadian industry's average of 3% to 4%. On the other hand, legislation in some states restricts some American companies narrowly at home and only one of them held any equities at all in Canada at the end of 1962.

Life insurance companies might be expected to find increased equity holdings an attractive investment for the long-term funds which they manage. However, the valuation difficulties already referred to, and a deeply ingrained conservatism stemming largely from the experience of some companies in the 1930's when only the use of specially authorized values enabled them to avoid technical

[23] The Superintendent apparently believes that a surplus of at least 6% of liabilities should be maintained.

[24] For example a company with stocks having a book value of 10% and a market value of 20% cannot trade any substantial part of these holdings against more attractive shares without breaking the rule because the Superintendent will not allow the new investments to be written-down substantially below market.

[25] 45 major U.K. life offices had 26% of their assets in equities in 1962, and some were considerably higher.

insolvency,[26] have contributed to a cautious policy. The philosophy of the legislation, and in some cases the 15% limit itself, also has a restricting influence. Finally, some companies have felt that fixed-income investments have been more attractive on balance, preferring to forego the higher returns expected from equities over the long run for the greater certainty of bond and mortgage returns, especially in view of the fixed-dollar nature of their liabilities.

In our view, there is little need for restriction on equity investments, since sound management and competent supervision of the industry could be relied on to ensure that no company built up too unbalanced a portfolio. However, it is true that because of the long-term nature of a life company's liabilities, today's investment errors may only lead to troubles many years hence. With this in mind some may wish to proceed slowly and maintain a limit on equity investments. We therefore recommend that the limit be raised to 25% of assets, as suggested by the C.L.I.O.A., and that the basket clause be raised to allow the companies to invest 10% of their funds in assets not otherwise eligible. We also recommend that the companies be permitted to hold equities and income-producing real estate in their basket clause investments in excess of the 25% and 10% limits.

If this greater freedom to invest in equities is used, there is perhaps some risk of a concentration of corporate control in the hands of life companies. There has been no evidence of such a tendency in the past because such holdings are small. If a tendency toward the concentration of share ownership were to develop it might be desirable to reduce the limit on individual investments from 30% of the shares of a corporation—perhaps to the 10% which applies to investment companies under the Income Tax Act.

These changes should free all companies to invest as fully in equities as they may wish, at least for some years to come. As with the changes in valuation rules, we would not expect dramatic changes to follow, but it might induce some companies to place more of their funds in the equity of Canadian enterprises.[27] We believe that a move in this direction, either by direct investment or through participation in development companies such as that mentioned in the previous chapter, would well serve both the policyholders and the economy as a whole. Increased purchases of equities would of course reduce the amounts which life companies would have available for other investments. While we believe that some re-direction of their funds would be useful, there is no reason for it to go beyond the point which the companies themselves find to be in the best interests of their policyholders. Compulsory purchases, which have been suggested to us, would be undesirable because they could seriously undermine the companies' sense of financial responsibility, harm the interests of the policyholders whose funds they manage, and would be an unwarranted infringement of the market system which would impair efficient economic development and innovation.

OTHER INSURANCE COMPANIES

The general insurance companies, including those life companies which sell insurance against sickness and accident and—in a few cases—against other risks, also obtain their funds largely on a contractual basis. In that they only provide protection against the specified risks and do not include any savings feature, the policies are akin to pure life insurance policies. The purchaser of general insurance does not accumulate financial assets in this way, he simply buys a service; these companies are thus not financial intermediaries in the full sense. However, they do accumulate pools of funds from premium and investment income out of which to meet claims under their policies, and thus they do manage portfolios of assets like other financial institutions.

[26] Although the declining value of large stock portfolios threatened technical insolvency, the companies would have been able to meet all their obligations without difficulty both at the time and thereafter; indeed, hindsight shows that if such holdings had been maintained, they would have been far more profitable than fixed-income securities.

[27] It should be noted that since they pay no tax on interest or dividends as such, the life companies do not have the same inducement as tax-paying investors to buy equities at reduced gross yields.

At the end of 1961, assets of $1,528 million were held by institutions doing a general insurance business, compared to $929 million in 1955 and $563 million in 1950. $1,408 million, or 92%, was in the hands of the 376 federally-registered companies subject to supervision by the Department of Insurance and the remaining 8% was held by some 90 provincial companies and more than 350 local insurance mutuals as well as members of the Lloyd's group. 108 of the federal companies are Canadian, 84 are British and 184 foreign, with the Canadian companies having 43% of the business and assets.

A high proportion of general insurance is written under short-term contracts, frequently covering three-year periods. For this reason, and because there can be much wider and more unpredictable swings in the claims against them than in the life insurance and annuity business, the net flow of funds to them is not so stable. Because of these factors, and the higher turnover of their funds generally, their cash holdings—5% of assets in 1962 for federal companies—are higher than for life companies. They also invest very little in mortgages, carrying more than 70% of their funds in bonds, a high proportion of them being Government of Canada and provincial issues which can readily be liquidated if need arises. The general insurance companies are a significant factor in the short-term market and some of them, particularly the Canadian ones, are also relatively large holders of preferred and common stocks in the less liquid part of their portfolios, although the total for all federal companies is only $113 million at book value, equal to 8% of assets.

INVESTMENT COMPANIES

The rapid growth of investment companies, which are intermediaries selling securities to the public and investing the proceeds in diversified investment portfolios, has brought them into increasing competition for long-term savings with other institutions and with the portfolio management services of trust companies and others. Closed-end investment companies in Canada, of which there are now some 23 with assets of more than $525 million,[28] sell debt and equity from time to time in the same way as industrial companies; their securities trade in the normal way on securities markets, although a number of them are closely held. They provide the investor with the advantages of professional management and diversification. Open-end companies or "mutual funds" also offer these benefits, but their only liabilities to the public are "special" or "Class A" shares which they stand prepared to sell and redeem at all times at prices based on the current value of their assets.[29] They thus facilitate regular purchases by small savers wishing to build up their investment gradually. There are some 65 mutual funds in Canada with investments of $1,200 million in 1962, including a number of recently established funds managed by trust companies.[30]

Like mutual funds in other respects, but without their professional management, are the investment clubs. Started in Canada in the late 1920's, it has only been within the past decade that they have experienced a rapid increase in numbers. To meet the needs of these clubs and to assist new clubs in forming, the Canadian Association of Investment Clubs was founded in 1955. It has been estimated[31] that approximately 1,000 such clubs are now in existence in Montreal and Toronto alone. The typical club has about 17 members with an average age of 41 years and making monthly contributions of approximately $11.00 each.[32] It has a net asset value of $9,400, an average rate of appreciation of 4.3% and holds 11 securities. The functions of these clubs are to enable the members to learn about investing and to put their savings to work

[28] *Financial Post 1963 Survey of Investment Funds*, page 28.

[29] The founders normally subscribe nominal amounts of common or "deferred" shares in order to comply with the requirements of companies legislation, although some funds are established under a trust indenture and sell units rather than shares.

[30] A number of mutual funds are associated with one another.

[31] Submission of Investment Dealers Association of Canada, Appendix J, page 45.

[32] C.A.I.C. *Newsletter*, July 1962.

in equities. A large proportion of these funds probably would not otherwise have found their way into the equity market.

The oldest of the present Canadian closed-end companies was formed early in this century and the majority date from the 1920's, only six having been established since 1940. Although one of the younger companies is now the largest, and although all companies' assets have expanded significantly—largely because their stock investments have appreciated—they have not grown as rapidly as the mutual funds in recent years. In the 1920's, many promoters and investors found closed-end companies a convenient way of extending their control of companies or improving the leverage on a given amount of equity investment. They would invest, say, $100,000 in the shares of a company, obtain $900,000 more by issuing debt securities and then buy $1 million of equities with the proceeds. If the underlying shares appreciated by 10%, they had doubled their investment, although if the shares fell by a similar amount they were wiped out. The unfortunate experience of some companies in the 1929 stock market crash destroyed public enthusiasm for this form of financing and there has been a tendency for the closed-end companies to rely less on debt and more on equity funds and to become less interested in speculation.

At the same time, investors have been attracted to the mutual fund form of diversified stock investment in which the value of each share is directly related to the current value of asset holdings. These funds are a relatively new phenomenon in the Canadian capital market. All but a few formed in the 1930's have been established in the past 15 years or so, a high proportion in the middle years of the 1950's when rapid economic development, price inflation and rising stock markets attracted attention to the advantages of equity investment. Among the other reasons for their rapid expansion have been the diversification of holdings they offer the small investor who would not otherwise have the resources to buy a wide range of equities; their professional management which relieves the buyer of the difficult and time-consuming task of choosing and managing a stock portfolio; their relative liquidity arising out of their redemption feature; and the convenience of long-term saving through their contract plans.

Not all the companies raise their funds in Canada. In 1954, the U.S. tax law was altered so that the returns to American investors from foreign investment companies would be taxed as capital gains rather than at higher income tax rates, provided all dividends were reinvested in additional shares. These non-resident owned (N.R.O.) funds grew rapidly until 1958 when their investments of $400 million were almost one-half of total Canadian mutual fund assets. The subsequent change in our economic circumstances and growing opportunities abroad lowered American enthusiasm for Canadian equity investment. More recently, U.S. tax laws have been amended to remove the advantage which had existed, and by 1962 the market value of N.R.O. fund assets had declined to $255 million. A few funds established to sell shares in foreign countries other than the United States have also failed to grow rapidly in recent years; at the end of 1962 two such funds had assets valued at $39 million compared to $38 million 4 years earlier.

The remaining mutual funds, most of which sell their shares principally to Canadians, have continued to expand at a very rapid rate. The market value of the assets of members of the recently formed Canadian Mutual Funds Association has risen from $57 million in 1951 and $252 million in 1956 to $834 million in 1962.[33] These funds had 282,000 shareholders at the end of 1962, compared to 22,000 in 1951, and the number is still growing quickly. The share of assets invested in equities by the industry as a whole has fluctuated within a narrow range around 80%, but there is considerable variety in the policies of individual funds. Most of the

[33] Membership in the Association is restricted to open-end funds organized and primarily owned in Canada, and the 27 members held 92% of the assets of such funds at the end of 1962. The new funds offered by trust companies had assets of $20 million; in addition trust companies operate many pooled funds with assets of more than $150 million for the investment of their small E.T. & A. accounts.

TABLE 13–4

ASSETS OF CANADIAN MUTUAL FUNDS[a]

(December 31)

—	1951		1956		1962	
	$ mn	%	$ mn	%	$ mn	%
Net cash and receivables	—	—	—	—	26.9	3.2
Bonds and debentures	—	—	—	—	111.5	13.4
Preferred Stock	—	—	—	—	46.3	5.5
SUB-TOTAL	10.5	18.5	59.4	23.5	184.7	22.1
Common Stock	46.2	81.5	193.1	76.5	649.5	77.9
NET ASSETS at market value	56.7	100.0	252.4	100.0	834.2	100.0
(Net Assets at cost)	(42.2)		(191.1)		(710.0)	
Number of shareholders	22,276		58,318		282,209	

[a]This table and the following one include only members of the Canadian Mutual Funds Association.

TABLE 13–5

MAIN TYPES OF CANADIAN MUTUAL FUNDS
DISTRIBUTION OF ASSETS, 1962

—	"Balanced" Funds		"Fully Managed" Funds		Bond Funds		Stock Funds		Specialty Funds		Total	
	$ mn	%	$ mn	%	$ mn	%	$ mn	%	$ mn	%	$ mn	%
Net cash and receivables	13.5	3.2	10.3	3.0	0.1	1.9	0.1	1.0	2.9	5.2	26.9	3.2
Bonds and debentures	73.4	17.4	33.0	9.6	3.5	97.0	—	—	1.6	2.7	111.5	13.4
Preferred stock	38.0	9.0	7.2	2.1	0.1	1.1	0.6	7.0	0.5	0.9	46.3	5.5
Common stock	297.1	70.4	292.8	85.3	—	—	7.6	92.0	51.8	91.2	649.5	77.9
TOTAL NET ASSETS	422.0	100.0	343.4	100.0	3.7	100.0	8.4	100.0	56.8	100.0	834.2	100.0
Number of Funds included	10		8		3		2		4		27	

large funds carry some bonds and short-term securities to limit the effect of swings in stock prices and dividends on their assets and earnings and to provide for unexpected redemption requirements.

Classifications of the funds according to their investment policies are somewhat arbitrary. In the United States, the funds' charters filed with the S.E.C. set out investment policies in some detail, specifying in the case of a "balanced" fund for instance that certain proportions of the portfolio will consist of bonds, preferred stock and common stock. In Canada, on the other hand, investment policies are stated more generally in

charters and prospectuses, relatively few funds having detailed investment restrictions. However, some funds tend to carry fairly substantial portfolios of bonds and preferred stock at most times and the term "balanced" fund is commonly applied to them. Others, known as "fully managed", are more inclined to shift their portfolios between these investments and common stocks depending on the state of markets and yields. Policies may change from time to time, but at the end of 1962, for instance, the group of so-called balanced funds included in Table 13-5 had an average of 70% of assets in common stock while the fully managed group had 85%. A small share of mutual fund assets is held by institutions with more restricted investment policies—bond funds, stock funds and funds which specialize in securities of particular industries or invest only in foreign securities.

Investment policies are influenced by the provisions of the Income Tax Act permitting an investment company a tax rate of 21% if it meets certain conditions. To qualify for the lower rate, 80% of its funds must be invested in stocks, bonds or other financial assets and they must provide 95% of its income; 85% of gross revenue must be from Canadian sources, not more than 25% from interest; and at least 85% of income after taxes must be distributed to shareholders. Not more than 10% of assets may be invested in securities of any one issuer, except securities of Canadian governments. Finally, there must be at least 50 shareholders, none of whom holds more than 25% of the funds' outstanding shares.

Between three-quarters and four-fifths of mutual fund investments are common stocks, principally issues of well-established companies, with all branches of industry represented. The bond holdings shown in Table 13-4, amounting to only $112 million in 1962, are nearly all federal and corporate issues, and the funds cannot be considered a significant factor in either market. On the other hand, their stock acquisitions and trading activity have undoubtedly influenced the behaviour of equities markets.

While it is difficult to assess the impact of mutual funds on the stock market, their purchases, which were equivalent to about 10% of net new stock issues in the decade ending in 1961, have almost certainly tended to raise equity prices. Some part of the funds flowing into mutual funds from their shareholders in the postwar period might have gone into stocks in any case, but much would probably not have. Indeed, representatives of the securities industry told us that favourable experience with mutual funds had led many investors who had not formerly bought common stocks to make direct share purchases themselves. In any event, the careful management of mutual fund portfolios has injected more professional judgment into the market which should serve to improve its allocation of funds.

We have studied the transactions of a number of funds closely in order to form a view of the industry's short-run impact on the market. The results, which are by no means conclusive, suggest that mutual funds tend to be stabilizing in a market decline and somewhat de-stabilizing in a market rise, although they do seem to have a moderating effect on the rise as the market nears its peak, often diverting more funds into the bond market to take advantage of the attractive yields usually prevailing at such times. There seems to be a fairly continuous flow of net new funds from contractual and other investors in mutual funds[34] which, while moderating market declines and intensifying upswings, is less volatile than individual investments in the stock market. Moreover, the mutual funds appear to be fairly selective in their buying and selling, thus often alleviating pressures that may exist on certain stocks. Finally, mutual funds and their shareholders are outright long-term owners not exposed to margin calls, and this imparts additional stability to their operations. At times, of course, they can be highly de-stabilizing, as the activities of the N.R.O. funds since 1954 attest. Nor is there any doubt that if Canadian mutual

[34] In this regard it is interesting to note that no major net redemptions have occurred in the industry and that even from September 1929 to December 1932 the U.S. mutual fund industry, then very small, experienced an increase in the number of shares outstanding. The same was true of mid-1962, when stock prices fell sharply. See the Submission of the Canadian Mutual Funds Association to the Royal Commission on Taxation, paragraph 21.

funds were ever to be liquidated on a substantial scale, the process would be both prolonged and painful in view of the size of their holdings, both absolutely and in relation to trading volume. However, such a development is unlikely, and less probable than mass selling by individual stock owners.

Both new money received and the appreciation of investments already made contribute to the growth of the funds. The experience of 11 funds which we studied varies quite substantially, but for the group as a whole about 65% of the increase in net asset values in the decade ending in 1961 resulted from the inflow of new funds and 35% from capital appreciation. Since the purpose of mutual fund investment is to buy a diversified group of securities, the stock portfolio of most funds tends to move in value with the main stock price indexes. While much depends on the skill and luck of individual investment managers, the funds' performance on average in years of rising stock prices is not quite as good as the D.B.S. Industrial Common Stock Index, while the reverse is true when markets fall. This results partly from the fact that debt holdings automatically restrain increases in the net asset value of each share when the stock portfolio is appreciating and cushion declines in less happy times.

The average value of the 300,000 mutual fund shareholders' investments is about $3,000 and an increasing proportion of them have invested by making regular payments rather than lump sum purchases. Under some instalment plans, the investor pays an acquisition fee averaging about 8% with each payment, and may stop his purchases and redeem shares at any time. The effect is thus not very different from a lump sum purchase, on which an 8% fee is also typically charged.[35] However, under many contractual plans stipulating for a series of payments over a number of years, the acquisition fee for the entire investment is frequently levied against the early payments. As a result of this "front-end loading", considerably less than 92% of early payments is credited to the investor, and if he wishes to redeem his shares early in the life of the contract he may suffer substantial loss. This is not peculiar to mutual fund investment—life insurance savings normally involve a similar loading of the selling charges on the early premiums[36]—but the consequences of the practice have not always been made clear to investors. A similar problem arises in investment plans under which the individual may withdraw stated amounts in regular payments: it is not always clearly explained that the withdrawals may exhaust his savings sooner than expected if the value of the fund portfolio does not continue to appreciate significantly.

It is important that these and other features of mutual funds be adeqately disclosed to the purchasers, many of whom are relatively unsophisticated. Disclosure is especially vital because the portfolio managers of the fund are often the same people as the distributors, and both groups may also be represented on the board of directors of the fund itself. As a recent United States study shows,[37] this situation can lead to undesirable conflicts of interest. Whatever the arrangements, the portfolio management organization typically receives an annual fee of about ½ of 1% of the fund's average net assets. Other expenses, such as fees for directors, custodian and legal services are relatively small for the large funds, in some cases as low as 3% of the portfolio management fee. In smaller funds, however, these other costs, which do not vary proportionately with the size of the portfolio, are sometimes as large as the management fee. Thus total expenses vary from about ½ of 1% to 1% of net assets. While these costs are not unreasonable, the investor should be clearly aware of them as well as of the acquisition charge and any "front-end load" arrangements.

In our view, there should also be full disclosure of the fund's investment policy, particularly as

[35] The fees are usually lower on larger single purchases.

[36] However, the buyer of life insurance is at least sure of insurance protection during the life of the policy, even though he will have paid a high price for it if he decides to let it lapse.

[37] *A Study of Mutual Funds*, prepared for the Securities and Exchange Commission by the Wharton School of Finance and Commerce—U.S. Govt. Printing Office, Washington, 1962.

to whether speculative purchases are made, of the extent of brokerage transactions with those who have any interest—direct or indirect—in the fund's affairs, and of any purchases or sales of securities of companies in which the fund's directors and managers are in any way involved. The present securities acts do not regulate mutual funds as such—no Canadian legislation does—but they do regulate mutual fund sales to the public. Investment companies are required to file a prospectus and financial statement making "full, true and plain disclosure" of all material facts, and usually do so annually. Prospectuses do not always meet the disclosure standards we have just suggested. Moreover, until recently regulation of mutual fund selling has not been stringent enough. In 1961, about one-third of the 10,800 securities salesmen registered in Canada were mutual fund salesmen, many of them untrained, and to whose qualifications the inadequately-staffed securities commissions gave only the most perfunctory attention.

Because of the rapid growth of the industry, the more frequent use of "hard sell" techniques and the occasional failure to inform investors of the risks of equity investment, and because of abuses by fringe operators which came to light in the United States, the securities administrators recently asked the industry to undertake some regulatory responsibility for itself. The industry, recognizing the need both for greater protection of the purchaser and for maintaining its own good reputation, subsequently held a series of meetings and in October 1962 formed the Canadian Mutual Funds Association, to which 27 funds and their sales agencies and management companies now belong.

In consultation with the securities administrations, the Association drafted a code of ethics and regulations which among other things prohibits funds buying on margin, selling short, or failing to disclose investment restrictions. It also limits investment to 10% of any issuer's securities except for government securities and shares of other mutual funds or investment subsidiaries. Moreover, to prevent conflicts of interest, it prohibits investment in a fund's management company, underwriter or a firm distributing its shares. It also strikes at a number of potential selling abuses, providing the buyer of a contractual plan involving a front-end load with 30 days to withdraw the funds invested without financial sacrifice if he changes his mind. It further requires distributors of fund shares to ensure that their sales representatives are properly qualified and trained before being allowed to solicit business. The industry is to be commended for these moves and should be able, if properly supported by securities administrators and legislation, to prevent the development of the abuses which have occurred in the United States.

The problem is not the same for closed-end investment companies, their shares being traded in the securities markets in the normal way. Some of them have no investment restrictions, while others specify in their by-laws or charters the amounts that may be invested in any one type or group of securities; sometimes these restrictions also limit part or all their purchases to dividend-paying securities traded on stock exchanges or to securities eligible for investment by insurance companies.

While greater competition for savings and less rapid rises in stock markets may well slow down the rate of growth of mutual funds, there has been no sign of this happening in recent years. On balance, they play a constructive role in mobilizing savings for equity purchases, particularly from smaller investors. They have also improved the workings of markets and can play a useful role in increasing Canadian ownership of domestic industry. Recent moves to increased self-regulation should help to insure that these constructive functions are not accompanied by practices detrimental to the Canadian investor whose interests it is their primary function to serve.

PENSION PLANS

The rapid spread of pension planning has been perhaps the most important change in the financial system since 1945. It has already had important effects on patterns of saving and invest-

ment—at the present time more than 30% of personal savings is made through the accumulation of pensions.[38] The assets held in trusteed pension funds have grown from an estimated $1,180 million in 1952[39] to $4,074 million in 1961 and $4,572 million in 1962, the annual growth rate having declined from about 16% to 13% during the decade. This growth has reflected—with some delay—the transition to an industrialized, wage-earning society in which an individual's own business and family can no longer be counted on to support him in retirement. Pressure from labour unions in their negotiations with employers has hastened the process, which has also been favoured by tax regulations permitting employers and individuals to deduct their contributions to pension plans from taxable income.

The pension and annuity business is not entirely new, the insurance companies having always sold annuities and the federal government since 1908 having made annuities of limited size available to the public. Individuals may purchase government annuities for up to $1,200, either separately or as members of a group annuity plan. In the year ending March 31, 1963, the Annuities Branch of the Department of Labour received contributions of some $37.5 million and paid benefits of $55.4 million on a total of 381,737 policies in force.[40] The premium income is used for the government's current needs—the plan is "unfunded" although separate accounts are kept—and since premiums have not been set at adequate levels, administrative expenses and a substantial part of annuity payments have been met out of the government's general revenues. The institution of Old Age Security payments and the proliferation of other pension and annuity arrangements have completely altered the situation for which government annuities were designed and have removed the need for this form of subsidy. We therefore support the recommendation of the Royal Commission on Government Organization that the sale of Government annuities be discontinued.

The main alternatives to Government annuities for pension plan administration, apart from similar schemes set up on a "pay-as-you-go" or unfunded basis, are insured administration with the life companies, savings through mutual fund retirement plans and trusteeship with a trust company or a group of individuals responsible for seeing that the terms of the plan are met. The pension agreement may involve only one "underwriter"—an insurance company, trust company or committee representing the group concerned—or some combination of two or more of them. For instance, government annuities may cover the first $1,200 of pension with additional benefits covered under an insurance company plan.[41] There is an even greater variety as to eligibility for membership, the rates of contribution by employees and employers, the way in which pension benefits are calculated and circumstances in which they may be drawn, and the conditions under which an employee may transfer pension rights from one plan to another ("portability"). In most Canadian plans the employee is required to make contributions at rates set out in the plan; the employer may also contribute at set rates or, in many cases, may vary his contribution with earnings, drop-out and mortality experience, being obligated to see that sufficient funds are available to meet the actuarial liabilities of the plans.

Sixty per cent of plans covered by the D.B.S. survey (which did not cover "pay-as-you-go" plans) are of the "money purchase" type—contributions are a stated amount or specified share of earnings, but the pension benefits depend on the amounts accumulated, and on investment earnings at the time of retirement. However, these

[38] If pension saving through life insurance companies—already discussed above—is excluded, the figure is just under 25%.

[39] The D.B.S. survey for 1952 reported $717 million of assets in industrial pension plans. No statistics on other trusteed plans are available earlier than 1957, at which time their assets of $838 million were two-thirds as large as those in the industrial plans. The estimate of $1,180 million for 1952 was made by applying this ratio, which has been fairly stable since 1957, to the figure for industrial plans.

[40] Since the business in force is continuing to increase—a situation which normally would lead to a surplus of receipts over benefits—a substantial element of subsidy was involved.

[41] The variety of arrangements is indicated in Table 29 of *Pension Plans, Non-Financial Statistics 1960*, a comprehensive survey of 8,920 plans recently published by the D.B.S.

plans tend to be small and include only 13% of members, while 75% of pension fund members are in plans which relate benefits to earnings in some way. Depending on rates of contribution, sufficient assets may be acquired year by year to meet a plan's present and future liabilities as calculated by actuaries or the contributions may fall short of this. In some cases the employer contracts to provide the funds necessary to meet the terms of pensions at the time when employees retire: this is known as terminal funding and since it is a liability accepted by the employer should be shown in the published financial statements. In plans which are not fully funded, the deficiencies may relate only to "past service liabilities" arising when the fund was started. Quite frequently, the plan calls for these deficiencies to be made up over a period of years by stipulated payments.

An important feature of pension plans is the "vesting" provision, that is to say the employee's right to contributions made on his behalf by his employer in the event that he changes jobs, retires or dies before the retirement age specified in the plan. In a fully vested plan, he is entitled to the benefits from all contributions as they are made. Shading down from the 29% of plans covering 5% of the members which are fully vested, there are a great variety of vesting provisions depending on years of service or length of membership in the plan, ending with the 3% of plans covering 31% of all pension plan members in which there is no vesting until the moment of retirement. Thus a plan may be fully funded in that adequate contributions have been made, and yet the employees are bound to the plan by the fact that they are not entitled to carry the full value of their own and their employer's contributions with them. This is the "portability" problem. On the other hand, a plan may be fully vested although inadequately funded or not funded at all—the employer is simply bound to make up the necessary amount on termination of an employee's service.

Smaller pension plans tend to be in the hands of insurance companies or to be administered by trust companies. The rapid growth of the insurance industry's annuity business, mentioned earlier in this chapter, has raised the amount of the future contractual annual payments involved in the federal companies' policies in force from $192 million in 1950 to $866 million in 1962. In the same period, annuity premium income has risen by about 275% from $59 million a year to $221 million, while insurance premiums increased just over 200% from $261 million to $807 million. Individual policies—some of them being part of a pension plan—have grown steadily but most of the expansion has been in group contracts which the companies offer in competition with other pension administrators and which now account for about 80% of the 724,196 annuity policies in force.

Insurance company plans offer advantages to individuals and small groups wishing to avoid inconvenience and expense in making their pension arrangements. Moreover, these insured pension funds are invested within the limits of insurance company legislation and the solvency of the plan is assured by the usual careful inspection by the federal Department of Insurance or provincial authorities. This close regulation has been one factor inhibiting the companies from devising new plans and tailoring them to the requirements of individual employers. In consequence of this and the vigorous competition from trust companies, they have found it difficult to attract large accounts. Although the introduction of their segregated funds may alleviate part of the difficulty, and although insurance companies have responded to the competition and are uniquely placed to underwrite pension liabilities, it remains true that in 1961 the average insurance company group had 69 employees while trusteed pension plans averaged 796: 160 of the latter had more than 1,000 employed members.

Trusteed plans and the way in which they are administered vary widely. Many of the large ones are trusteed with individuals, typically a group including officers of the employer concerned or others connected with the plan's members. A pension fund society is a similar form of trusteeship in the hands of a committee representing the employer and members of the plan; it is common

for large funds. Some smaller funds are also administered in one of these ways, but the great majority are under "corporate trusteeship"—i.e. administered by a trust company. They may be individually managed—investment responsibility often being shared with representatives of the group concerned—or as is commonly the case with small plans, the funds may be combined for investment with other funds under common trust arrangements.

TABLE 13–6

TRUSTEED PENSION PLANS—1961

—	Number of Funds with assets of:			All plans		
	Less than $5 mn.	$5 mn. to $25 mn.	$25 mn. and over	Number	Total Assets	Average Assets
					$ mn.	$ mn.
Trust companies:						
Individually managed	357	32	4	393	938.3	2.4
Other	718	4	1	723	181.5	0.3
TOTAL	1,075	36	5	1,116	1,119.8	1.0
Individual trustees	165	26	20	211	2,485.0	11.8
Pension fund societies	19	9	8	36	469.3	13.0
TOTAL	1,259	71	33	1,363	4,074.1	3.0

TABLE 13–7

ASSETS OF TRUSTEED PENSION PLANS, 1961

—	Trust Companies		Pension Fund Societies	Individual Trustees	Total	
	Individually Managed Funds	Pooled Funds				
	percent				$ millions	percent
Bonds—Govt. of Canada	9.2	2.9	9.5	18.8	602.4	14.8
Provincial	18.7	4.4	16.1	42.3	1,309.9	32.2
Municipal	12.1	1.8	26.9	7.9	439.9	10.8
Other[a]	31.9	14.3	21.1	10.6	688.4	16.9
TOTAL	71.9	23.4	73.6	79.6	3,040.6	74.7
Stocks—common	17.1	3.9	7.9	6.9	374.8	9.2
preferred	0.6	0.5	1.1	0.3	18.4	0.4
TOTAL	17.7	4.4	9.0	7.2	393.2	9.6
Mortgages and real estate	7.4	2.6	14.4	9.3	374.3	9.2
Pooled and mutual investments[b]	—	66.7	0.3	1.6	161.5	4.0
Other assets	3.0	2.9	2.7	2.3	104.6	2.5
TOTAL	100.0	100.0	100.0	100.0	—	100.0
TOTAL AMOUNTS	$938.3 mn	$181.5 mn	$469.3 mn	$2,485.0 mn	$4,074.1 mn	

[a]Canadian corporate and a small amount of foreign bonds.
[b]These funds are invested largely through the trust companies' own pooling arrangements in a variety of assets.

SOURCE: *Trusteed Pension Plans 1961, Table II.* D.B.S. publication no. 74-201.

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Just as there is great variety in the forms of trusteeship and administration, so the investment policies of pension funds may differ substantially from the aggregate statistics shown in Table 13-7. One common feature is that a high proportion of funds in government plans tends to be invested in issues of the employer or of similar borrowers. Thus the high proportion of municipal securities held by pension fund societies reflects the fact that 10 of the 36 societies are for municipal employees. Similarly the large provincial funds are heavily represented among plans with individual trustees, and it will be noticed that 42% of these funds are invested in provincial securities. Clearly pension fund investment decisions—particularly in plans at each level of government—are not made exclusively in terms of yields available on different assets. At the extreme, some funded plans administered by provincial governments hold only non-marketable long-term obligations of the government concerned—which is virtually equivalent to operating an unfunded plan. Given the size of the flows involved, this tendency to disregard market considerations on the part of many funds, particularly some of the large ones, can lower both the returns to members on their pension savings and the efficiency of capital allocation in the market.

About 10% of the market value of trusteed plan assets is invested in corporate stock. In view of both the assured growth and term nature of pension fund liabilities, this is surprisingly low. In many cases, the explanation lies in the bias towards investment of public pension funds in government securities, but it is also true that the administration of many funds has tended to be conservative to a degree perhaps not justified by the need for protecting the pensioners' interests.

On the other hand, the trust companies, which compete actively for pension accounts on the basis of their ability to perform well as investment managers, have tended to invest a considerable share of their pension funds in equities. In 1961, 18% of the assets of funds managed individually by the companies were in stocks and the ratio for pooled funds was about 25%.[42] Moreover, the share of equity investment is rising: more than 30% of the reported increase in assets of individually managed trust company accounts during 1961 was in corporate stocks. For all trusteed plans covered by the D.B.S. survey, stock holdings increased by about $120 million in 1961, which was 27% of the increase in book value of trusteed pension assets. Canadian stocks accounted for $95 million of the increase; while most of the purchases were not of newly-issued stock, their acquisitions may be compared with net new stock issues of $250 million in that year. Thus although many pension fund administrators still shy away from stock investments, those that have found them attractive now play a major role in the equity market. Many of them also trade their portfolios actively as they try to improve their funds' performance, and they switch their holdings as market yields and prices dictate. The investment income of funds with more equity investment has been about the same as that for all trusteed plans, which rose from 3¾% to about 4½% of year-end assets from 1957 to 1961, but they have benefited from the appreciation of stock portfolios as well.

One would not wish industrial plans to invest in the employer's own stock, for this raises serious conflict of interest problems, may have undesirable effects in helping management to put itself above the interests of the shareholders, and also exposes the employee to the risk of losing both job and pension if the company should run into difficulties.[43] On the other hand, careful and diversified stock investment seems a reasonable and obvious use for a somewhat higher share of pension funds.

Although the investment of annuity and pension funds in the hands of life companies and the solvency of these plans is governed by the insurance legislation, there is no regulation of other pension funds and no restriction on their investments beyond what may appear in the individual agreement or by-laws. This is an anomalous situa-

[42] This includes part of the 66.7% of funds shown in Table 13-7 as being invested in "pooled and mutual investments".

[43] The by-laws of most industrial pension plans in fact prohibit such investments.

tion; the protection of the individual's savings is every bit as important in trusteed as in insured pension plans or life insurance and is perhaps more logical in that he frequently has no option but to invest a substantial share of his savings in this way as a condition of employment. It is also more necessary in that the competence of pension fund administration varies greatly—from the plans managed by skilled financial experts to those which are in the hands of less qualified administrators. There has been no evidence of abuse in Canada as yet, but it hardly seems wise to wait until misfortune brings a cry for excessively restrictive legislation.

We therefore think it desirable that the provincial and federal authorities co-operate in establishing broad investment rules, the first of which should prohibit investment in the employers' own securities or other investments raising the possibility of conflict between the pensioners' interests and those of the fund managers. An exception could be made for plans administered by the federal or provincial governments: municipalities should adhere to the general rules although exceptions might be made subject to provincial approval. In order to ensure appropriate diversification of assets, all funds should be prohibited from investing more than 10% of their funds in securities of any one issuer with the exception of federal or provincial issues.

In addition to these prohibitions, a pension plan should be limited to investing in assets eligible under the federal insurance legislation, including a 10% "basket" clause for assets not meeting the quality requirements. We understand that virtually all trusteed plans do now invest within these limits. However, many plans hold more equities than the 15% now allowed to life companies and some exceed even the higher insurance company limits we have recommended. Plans in which all or part of the benefits depend on the performance of the fund (money purchase plans) are similar to the life companies' variable annuities and can like them appropriately be free of any quantitative restriction on stock holdings. Indeed, there is good reason to invest them in equities if there are good prospects of increased earnings and dividends. On the other hand, it is reasonable that plans in which the fund is committed to meeting fixed-amount benefits should invest more heavily in fixed-value assets and avoid the risk of over-investment in equities. Between these extremes, investment policy must be attuned to the type of benefit written into the plan as well as to market prospects. In view of the great variety of plans, we hesitate to recommend that specific quantitative rules be imposed.

Even if funds are wisely invested, it is important to see that they are adequate to meet the terms of the pension plan. There must be enough assets to meet actuarial liabilities, or formal arrangements must be made to ensure that funds will unquestionably be available. We believe that the authorities, whether provincial or federal, should require annual reporting on all funds, including periodic reports by an independent actuary, to see that these standards are met. Indeed, we wish to emphasize that such regular examination is more important than the imposition of arbitrary investment restrictions. The Ontario "Portable Pensions" legislation sets out such rules for private pension plans in all establishments of 15 employees or more, however they may be administered.[44] A period of years will be given to make up any actuarial deficiencies arising out of past service benefits. In addition, it will require that all contributions made on behalf of an employee be fully vested in him as they are made.

If full funding is to be required of all the private plans now in existence as is proposed in Ontario for the minimum benefit requirements of the Act the many plans with actuarial deficits will have to acquire substantial additional assets over a period of years. This increase in the pools invested by pension administrators, financed out of employees' and employers' current incomes, could conceivably result in substantial extra saving in the economy and have a material effect on financial markets and incomes. While other forms of saving would almost certainly be reduced, the net effect would very probably be

[44] The full title is "An Act to provide for the Extension, Improvement and Solvency of Pension Plans and Portability of Pension Benefits".

to increase the amount of capital available in Canada to finance governments and industry.

We do not have the data on individual plans necessary to make actuarial calculations, but discussions with pension actuaries suggest that the $4.6 billion of assets now held by trusteed plans may be $2 billion or more below the amount required for full funding. Taking this estimate for illustrative purposes and assuming that funding were to be carried out over a 25 year period, the extra annual payments would be about $125 million at 4% interest. This would represent an increase of about 20% over the rate of contribution to pension funds and other retirement plans in 1961; the ratio would be considerably lower for the period as a whole since normal contributions will grow substantially.

If one goes on to consider the problem of financing universal government pensions with generous levels of benefits, the magnitudes involved become much larger. Indeed, they raise serious questions about the ability of the economy to support such pension benefits and about the consequences for financial markets of different contribution arrangements. In addition, sizable public pensions would almost certainly involve a considerable expansion of the role of government in the economy.[45]

Though the Commission has made no thorough study of the proposed Canada Pension Plan, we venture to call attention to some considerations which are relevant to our terms of reference. This federal plan would provide those over 70 with pensions building up to a maximum of $75 a month 10 years after it is initiated; these benefits would be additional to Old Age Security benefits of $75 a month.[46] Some classes of workers, such as farm labourers, domestic servants and the self-employed, will not be required to participate, but may do so if they choose. According to the Government's calculations, the cost may rise to between 3% and 3.4% of contributory earnings—that is, earning up to $4,500—by the year 2000. On the assumption that Old Age Security benefits are adjusted in step with changes in average earnings, their financing is expected to cost at least an additional 5½% of contributory earnings. While all such estimates of future costs are bound to be uncertain,[47] it is clear that the plan involves drawing off substantial amounts of personal savings for distribution to pensioners. Even though our national income per capita is about 30% lower than in the United States and welfare payments already account for a larger share of our national production, the Old Age Security and pension plan benefits to be paid to a retired couple who have had earnings of $400 a month will exceed those in the United States by 17%, and by higher amounts at lower income levels.

The Quebec government plans to introduce legislation to establish a plan which will involve the accumulation of a fund for investment. No details are available at present, but the government apparently intends to use the funds received in excess of benefit payments to assist in financing its own requirements and possibly to invest in industry.

Whether or not a plan is funded, the financing of universal pension benefits and the increased payments made to pensioners are certain to affect spending and savings habits in the community and the workings of the financial system. An ambitious plan can be expected to have particularly important consequences, especially if the financing of a high level of benefits in relation to personal income and saving strains the economy's real resources and dislocates saving and investment. There is a limit to the amount of goods and services which the working population will be willing to produce for consumption by retired people. There is also a limit to the amount of supplementary private saving one can

[45] In the following comments on government pension plans we have left aside such important matters as the fairness of contribution and benefit rates to individuals or to groups of members since these matters are not within our terms of reference.

[46] Under certain conditions, participants in the plan would be entitled to begin drawing pensions at age 65.

[47] The U.S. Social Security system was originally established with contributions of 2% on earnings up to $4,800. Since 1937, the rate has risen to about 7% and will rise to 9.25% in 1968, a result in part of the extension of coverage and benefits. It is only reasonable, however, to assume that benefits will move continuously upwards over the years.

expect if contributions to a national scheme, whatever form it takes, absorb a substantial part of the current income people are willing or able to devote to providing for their future: in such circumstances there is every reason to expect a sharp decline in other forms of saving.

There will be differences in the impact of a comprehensive government plan depending on whether or not it is funded. To the extent that the plan is funded a pool of funds will be made available for investment by the government's pension fund administrators. The consequences of this change for economic and financial conditions will depend on how much the savings which had previously flowed into investment through the hands of private pension administrators are reduced and redirected, and on the use to which the new government funds are put. If as proposed,[48] the latter are used to finance government spending, there will be a reduction in the need to sell government securities to other holders, including the long-term financial institutions. Governments, having a captive source of finance, possibly at favourable rates, might well be inclined to spend more freely than they otherwise would. Alternatively, the funds might be invested in a broad range of public and private securities to replace the investments which private institutions and savers would have undertaken. At the very least there will be a shifting of functions from the private to the government sector, which will be in a position to exercise a direct influence on the allocation of a large share of the community's savings and might indeed come to dominate a large part of the financial system. Professor Lundberg discussed with us some of the difficulties encountered in Sweden where the administrators of the national pension scheme, which is partially funded, have become not only important arbiters of capital and resource allocation, but also a centre of financial power whose decisions can influence the government's financial and monetary policies.[49] Arrangements of this sort would be a substantial departure from the accepted roles of the private and public sectors in the Canadian economy.

Since there is normally no question of the central government's ability to meet pension obligations and it is therefore unnecessary for it to ensure solvency by accumulating a fund of investments, it is often thought best for the government to avoid the problems of managing a potentially massive portfolio. If the government therefore finances its pensions entirely on a "pay-as-you-go" or unfunded basis, it channels funds from the working population directly to those who are retired and who are unlikely to save or invest any significant part of them. Under these arrangements, there are no savings accumulated in the hands of government pension administrators which could substitute for the private accumulation of savings through funded retirement plans, and the supply of investible funds may well be reduced. With a growing population, a given level of benefits can be financed through an unfunded plan with lower contributions than would be called for in a funded scheme; alternatively, benefits may be increased earlier than would otherwise be the case so that the working population is required to set aside just as much of its current income for the pensioners as under a funded plan.

The end result of such changes from present methods of financing pensions through private funds cannot be foreseen with any certainty. It will depend on the levels of contributions and benefits and the impact they have on saving by the working population and on spending by retired people. It is possible that in circumstances of less than full employment the stimulus to spending may initially generate higher income levels out of which new savings will flow into investment through the established channels.

[48] The federal government's proposal of January 1964 is for a partially-funded Canada Pension Plan; after 10 years, a fund of $2½ billion (excluding interest) would be accumulated, at which time the fund would still be growing. One half of the funds would be invested in provincial debt in proportion to the provincial distribution of contributions, and the remainder in federal government securities.

[49] Submission of Professor Erik Lundberg and transcript, pages 4349 ff. Professor Lundberg explained that the level of funding chosen was that considered sufficient to offset the potential decline in other forms of saving: even with partial funding, Professor Lundberg estimates that the fund is now equivalent to one of $15 billion in Canada.

However, the government can work towards full employment in other ways; the stimulus from this source would not be continuing and could better be achieved in other ways which less seriously impair the government's ability to pursue stabilisation policies.

It is in fact all but certain that the financing of a national pension scheme with relatively high benefit levels would result in a substantial reduction in the funds available for investment in the mortgages, bonds and equities which the savings institutions acquire. A change of this type in resource allocation in the economy and our financial arrangements might well take us into a new situation in which the experience of past market developments would have only limited relevance. A serious reduction in domestic private financial investment would fall most heavily on municipal and provincial governments and on business, agriculture and housing. It might well lead to increased reliance on investment by non-residents and necessitate steps by the federal government to see that adequate levels of capital formation are financed in one way or another. Given the higher levels of consumption which could be expected to follow from the transfer of income to retired people, an adequate level of investment might place too heavy a demand on the economy's physical resources and intensify the difficulties of combating inflation. No method of financing enables one to escape the fact of a limit on the economy's ability to provide goods and services for those who are no longer working.

We emphasize that in stating these problems we are not arguing against the desirability of seeing that Canadians provide themselves with adequate retirement income. We are simply stressing the necessity of considering each step along the way with the greatest care, particularly where the vital savings and investment process is involved. We have no panacea to put forward, although we do urge that any proposed pension legislation take account of the price that will have to be paid in terms of the financing of our national development. The magnitudes involved are potentially so great, especially if contributions were to rise over the years, that in our view a cautious, gradual approach should be taken to ensure that achievement of the immediate objective does not bring with it undesirable consequences. In a world of scarce resources it makes sense to consider carefully before making irrevocable decisions affecting the economic welfare of all Canadians.

CONCLUSION

The growth of long-term savings institutions, some of them very large, has not led to the concentration of economic power which some had feared, partly because the business is shared by many insurance companies, mutual funds and pension plans and partly because most of them like to obtain regional and industrial diversification in their portfolios. Nor does the growth of contractual saving appear to have affected the level of personal saving, which has remained a remarkably steady proportion of personal income over the years. This so-called "institutionalization of savings" seems, if anything, to have enlarged equity purchases on balance. This is because the institutions themselves, especially mutual and private pension funds, invest more in equities than many of their individual contributors could or would do on their own. Moreover, those with surplus savings appear to be willing to invest heavily in equities after having met their primary requirements through the institutions: it will be recalled from Chapter 10 that over half the funds in estates managed by trust companies are invested in Canadian equities. While the long-term institutions cannot supply large amounts of high-risk venture capital directly, they can supply it indirectly through participation in development companies, and should step up this activity. As we mentioned, the life companies could appropriately expand their direct purchases of equities as well.

Unless developments are affected in a major way by the nature of government pension legislation, it seems likely that all three major classes

of intermediaries described in this chapter will come into increasing competition with each other: life insurance companies, in addition to their normal functions, will become increasingly like investment trusts competing for the management of investors' funds; pension funds may well add more of the protective feature of life insurance to their benefits as well as becoming increasingly sophisticated in their investment programs; and finally, the mutual funds will probably come to depend more and more on retirement-savings plans as a major source of their growth. It is with such factors in mind that we have suggested a framework of regulation which will allow this competition to be effective over a wide area while still protecting the interests of the small investor who is the ultimate source of much of the funds of these major institutions.

CHAPTER 14

THE RESIDENTIAL MORTGAGE MARKET

Although the annual volume of secondary trading in mortgages is small, the amount of net new residential mortgages marketed in the post-war period has exceeded that of any other type of financial asset. This big and important part of the financial system has grown rapidly in response to vigorous demand generated by an expanding population, rising income levels and a backlog of housing needs accumulated during the years of depression and war. These high requirements for funds to finance new housing construction, repairs and renovation, and sales of existing housing have powerfully influenced the growth of both new and established financial institutions; their response to these continuing needs has in turn led to many improvements in the facilities offered to those seeking mortgage money. Nevertheless, the federal government has played a major role in the mortgage market as a direct lender and insurer of private loans in addition to unifying and improving the standards of mortgage financing and residential construction.

At the end of World War II, Canada's housing stock was low relative to the needs of the population and much accommodation was in need of repair. In succeeding years, growth of the population increased the demand for new housing, as did the movement of people from one part of the country to another. Changes in the structure of the population also added greatly to the demand—family formation rates were high until 1957, and many families moved out of homes which they had shared with others into homes of their own. Given the high and rapidly rising levels of personal income, these underlying demand factors led to high rates of residential construction expenditures, which rose from $700 million right after the war to a peak of $1,722 million in 1958 (both measured in 1957 dollars). These outlays have accounted for 24% of all private fixed investment expenditure in the postwar period as a whole.

In more recent years, the supply of dwellings has been brought into better balance with the demand. This has been one of the factors contributing to some reduction in the rate of new construction, which in the three years 1960-62, averaged $1,349 million (measured in 1957 dollars) compared to $1,722 million in 1958 and $1,633 million in 1959. Other important factors in this development have been the slower growth of real personal incomes and a marked decline in the rate of new family formation and immigration.

These post-war developments in the housing market have had major consequences for the financial system. As pointed out in earlier chapters, many of the institutions willing and able to invest in mortgages have enjoyed rapid growth rates and good profits. In addition to the established mortgage lenders such as life insurance, trust and loan companies, new mortgage lenders have emerged. In 1948, the savings banks were first allowed to invest in conventional mortgages and in 1954 both they and the chartered banks were permitted to acquire N.H.A. mortgages. More recently, other institutions such as sales finance companies have begun to move into the field. Throughout the period, however, the federal

government has, in varying degree, assisted the financing of residential construction for reasons of economic and social policy.

From 1945 to 1962, the estimated total amount of mortgage debt outstanding rose from about $1.3 billion to some $14.2 billion, or from 5% to about 20% of all forms of primary debt outstanding. These figures include estimates of the amounts of mortgage debt held by individuals as well as the reported amounts held by the financial institutions, by governments and their agencies, and by non-financial corporations. The increase of $13 billion in mortgage debt may be compared to a net increase of $2 billion in federal government debt outstanding over the 17 years, and to increases of $7 billion, $3 billion and $6 billion in outstanding provincial, municipal and corporate securities respectively.

These mortgage figures include substantial amounts of business and farm debt. Although we unfortunately do not have full information on all such mortgage lending, particularly that granted by non-financial corporations and individuals, we have estimated that some $6½ billion of the $8½ billion in mortgages held at the end of 1961 by financial institutions and governments, or 77%, was secured by residential property. Assuming a comparable proportion in the holdings of other lenders,[1] the total amount of residential mortgages outstanding would be of the order of $10 billion in 1961. At that time, there were 4½ million dwelling units in the country having an estimated value of between $40 and $45 billion—including land—so that mortgage indebtedness represented approximately 25% of property values. This rough relationship is borne out by our own consumer survey in which mortgage debt was reported at about 30% of the value of dwellings.

Loans secured by residential property are used to finance the construction of new housing, for repairs, renovation and transfer of existing properties, and for a variety of other purposes not directly related to housing finance. There has been some evidence in recent years that borrowers are making increasing use of mortgages on their homes to obtain funds to meet other needs such as education costs or major durable purchases, but the largest source of demand—and the most important in its effects on employment and economic activity—remains that for new construction. Since the end of the war, 75% of the amount of residential lending approved by the main financial institutions has been for new construction, while government residential mortgage lending is almost exclusively for this purpose. Individual lenders also supply mortgage funds for new construction but a much higher share of their lending is secured by existing properties.

Thus, the relatively small share of the housing stock built each year provides the main source of demand for mortgage funds. Moreover, such new construction depends heavily on borrowed funds compared, for instance, to the relatively low use of external finance by businesses referred to in Chapter 3. As shown in Table 14-1, the owners'

[1] This assumption is supported by a survey of mortgage registrations by individual lenders in Ontario in 1958, in which 77% of the total amount was secured by residential property.

TABLE 14–1

SOURCES OF FUNDS FOR EXPENDITURE ON NEW HOUSING
(annual averages)

	1954–1957		1958–1962	
	$ mn	%	$ mn	%
Owners' equity	269.7	18.7	291.0	17.8
Federal Government				
—CMHC	46.4	3.2	276.5	16.9
—other[a]	37.8	2.6	36.6	2.2
Lending Institutions				
—N.H.A.	406.9	28.2	357.0	21.8
—Conventional	194.1	13.5	308.2	18.8
Other Financing[b]	487.4	33.8	367.7	22.5
TOTAL EXPENDITURES	1,442.3	100.0	1,636.8	100.0

[a] Includes public housing such as armed forces dwellings and joint Federal-Provincial housing.

[b] Mortgage lending by caisses populaires and credit unions, which are not approved lenders under The National Housing Act, is included with credit extended by individuals and non-financial lenders in this "other financing" total.

SOURCE: *Canadian Housing Statistics.*

equity in new housing has provided only 18% of the funds needed for construction since 1954, with 82% coming from financial institutions, government agencies and other outside sources. Borrowed funds are the principal source of finance for all but a relatively small number of houses and apartments built: in 1962, institutional and government funds were the main source of finance for 106,995 of the 130,095 dwelling units started, and money borrowed from other lenders undoubtedly provided the principal financing for most of the remaining 23,100. The market for new housing can thus be powerfully affected by the way in which the mortgage market is organized and allocates funds among competing needs and by changes in the availability of mortgage funds.

CHARACTERISTICS OF THE RESIDENTIAL MORTGAGE MARKET

The basic characteristics of the residential mortgage lending process, and of the mortgage instrument itself, do much to determine the nature of the mortgage market. Residential mortgages are long-term loans secured by individual pieces of real estate with widely varying characteristics as to location, type and age of building and quality of construction. Such loans are normally supported by the borrower's personal covenant to repay, but the amounts involved are normally so large in relation to the borrower's income that—apart from ensuring as far as possible that the borrower is not over-extended or unwilling to honour his commitments—the lenders must look primarily to the property itself as the ultimate security for their funds[2] and must therefore be skilled in appraising property values and building standards. Moreover, unlike corporate or government securities, most mortgages—except those on large apartment buildings—must be issued in relatively small amounts; the average loan on new single family houses was about $13,400 in 1962, while loans on existing houses averaged $8,310.

Individuals can and do lend substantial amounts on mortgages but mainly in circumstances where they know the situation or where their occupation gives them special skills in the field. A considerable amount of such lending also arises from the sale of housing, the vendor taking back a mortgage to complete the transaction or realize a higher price. However, institutional lenders with the organization and skills necessary to appraise properties and administer portfolios of mortgages at reasonable cost provide a larger share of the funds. Because of the individual nature of each mortgage and the resulting decentralized character of the market there is little trade in outstanding mortgages compared to the secondary market turnover in stocks and in many types of bonds. Institutional and other lenders tend to originate their own loans and keep them until final repayment, and the dominance of these long-term lenders in the market tends further to reduce turnover and marketability. This in turn tends to limit the supply of funds from investors with significant liquidity needs. Flexibility in the market is further reduced by the elaborate legal arrangements and consequent costs of real estate and mortgage transactions and by the variety of prohibitions and restrictions applying to mortgage investment by financial intermediaries referred to in earlier chapters.

(i) *The National Housing Act*

The structure of the market for new housing finance is in large part determined by the terms of the National Housing Act and the operations of Central Mortgage and Housing Corporation under it. Since passage of the Dominion Housing Act in 1935, the federal government has played an increasingly important role in the housing market. This piece of legislation, and the first National Housing Act which replaced it in 1938, were designed to increase spending on new housing with the twin purposes of increasing the housing stock and stimulating economic activity, while the companion Home Improvement Loans Guarantee Act of 1937 was intended to promote

[2] Because of the character of the security, the lender is often willing to allow a subsequent purchaser to assume the liability for an existing mortgage (or to arrange modification of its terms). While such transactions give rise to substantial gross flows of credit to purchasers from vendors, the net flows of mortgage credit are not changed.

spending on housing repair. The principal technique introduced in 1935 was the joint mortgage loan under which the government put up 20% of the property value at 3% interest and private institutions obtained a higher rate, 5.66%, on their share, which could vary from 50% to 60% of property value and was covered by partial insurance. The result was to make mortgage funds available more cheaply than otherwise. Moreover, the amortization period of 20 years was longer, and the maximum loan of 80% was larger, than was available in normal mortgage lending. Relatively low rates, long amortization periods providing for regular monthly repayment of principal, a high ratio of loan to property value and the insurance of private institutional lending are still the most important elements in the financial side of the government's housing policy.

In addition, the 1935 legislation established minimum construction standards for building financed under its provisions, and the government has continued to work for improvement in the quality of housing by insisting that the security for mortgage loans it grants or guarantees meet high construction standards. The early housing legislation had a number of other features designed to stimulate construction activity, such as special terms favouring borrowers with low incomes and those living in small and remote communities; there was also provision for loans to corporations paying limited dividends which undertook to build low-rental housing projects. However, residential construction remained at low levels during the late 1930's and was, of course, severely restricted during the war. The total amount advanced from 1935 to 1944 under all parts of the housing legislation was only $87 million.

In order to assist in meeting the housing shortage resulting from these years, a new National Housing Act (N.H.A.) was passed in 1944. In the following year, the Central Mortgage and Housing Corporation (CMHC) was set up to administer this Act, which now included the Home Improvement Loans guarantee legislation, and to be the government's agent and advisor in matters of housing policy. The policies laid down in previous legislation were maintained, and the Act was extended to provide for federal loans covering 50% of the cost of municipal slum clearance projects. Despite amendments in succeeding years which broadened CMHC's direct lending powers—particularly the 1947 amendment enabling the Corporation to make loans in small or remote communities where private lending institutions were not providing joint loans—the joint loan remained until 1954 the principal type of lending under the N.H.A. Eighty-six percent of the $1,351 million of loans approved under the Act from 1946 to 1954 were of this type.

In 1954, a revised National Housing Act replaced the joint lending arrangement with a system of insuring loans made entirely by approved private lending institutions; provisions for direct lending by CMHC, loans to limited dividend companies, rental guarantees and home improvement loans were, however, retained. The Corporation was also empowered to buy and sell insured mortgages. The main purpose of the changes was to increase the flow of new housing mortgage funds from private institutions, and to this end the chartered banks and Quebec savings banks were also permitted to make N.H.A. mortgage loans by amendment of their own legislation. Whereas insurance of joint lending applied to the institutions' business as a whole, it applies to each individual loan under the present scheme and may therefore be transferred with the loan. This is essential if the mortgages are to be sold by the first lender to other investors and if a range of private N.H.A. lenders without the facilities and skills to initiate loans is to be attracted into the market. The insurance, which the borrower pays for[3] and which the lender may

[3] The fee is 2% for home ownership property and 2½% for rental property. Fees go into a reserve fund, amounting to $102 million at the end of 1962. The fund is about 2% of outstanding N.H.A. mortgages and has certainly been adequate for the claims made on it to date; these have amounted to about $12 million from 1954 to 1962. The present level of fees appears adequate for all normal circumstances, although a major depression might deplete the fund. If that were to happen the claims would fall directly on the government, which stands behind the insurance fund.

claim if he chooses not to retain the property mortgaged by a defaulting borrower, covers the full amount of principal outstanding, as well as interest for a number of months, taxes due and some of the lender's costs.

The terms of N.H.A. loans have changed considerably over the years; there have been a number of increases in the size of loan permitted and the amortization period as well as changes in the maximum rate of interest allowed.[4] At present, loans to home owners may be made for 95% of the first $13,000 of property value (as determined by CMHC) and 70% of the remainder up to a total loan of $15,600 on houses with four or more bedrooms and $14,900 on smaller houses. The maximum term is 35 years, and lenders may not require repayment in less than 25 years, although the borrower may not want such long amortization and some loans are written for periods as short as 15 years. In lending to home owners the lender must try to ensure that annual payments on the mortgage and property taxes are not more than 27% of the borrower's income.

Loans on apartments and other rental property may not exceed 85% of property value. Until 1963, the maximum loans allowed on rental property were considerably below those on individually owned homes, but at present they are the same—$14,900 or $15,600—for all types of rental property other than apartment buildings for which a maximum of $12,000 for each unit is imposed. The maximum term of 35 years is the same as for home owners. Thus the previous policy of favouring home ownership over rental accommodation has been pretty well abandoned. In view of the population's changing housing needs and the advantages of renting for those obliged to move frequently, we take this to be an appropriate change.

A maximum rate of 6¼% now applies to all N.H.A. loans other than CMHC's special lending to limited dividend companies, to universities for student housing and for slum clearance and joint low-rental housing projects undertaken with the provinces; the rate on such loans is 5⅛%. Virtually all mortgages are written at the maximum rate. Since 1954, the rate has been changed only 7 times, varying from a low of 5¼% set in February 1955 to the level of 6¾% which prevailed from late 1959 until November 1961.

(ii) *The Conventional Mortgage Market*

N.H.A. residential loans are available only for new housing, and their terms are considerably more favourable to the borrower than those on conventional mortgages on new or existing property. Although the repayment period on conventional lending has lengthened considerably owing to successful experience with N.H.A. lending, to the general acceptance of regular amortization schedules and to competition among lenders, the term of much conventional lending—particularly mortgages on existing properties—is still shorter than the 26 year average for N.H.A. loans. In the case of life insurance company lending on new property, there is probably not much difference: amortization periods of 20 or 25 years are common and some mortgages are now written for 30 years. Moreover, a good deal of lending on recently-built houses is written on the same basis as that applying to new properties. On most existing housing, however, the average amortization of loans is closer to 15 to 20 years, reflecting its greater obsolescence or the prospects of older neighbourhoods declining in value.

Trust and loan companies, which are more exposed to changes in the cost of their own borrowed funds and which often hesitate to commit their E.T. & A. accounts for long periods, generally prefer shorter terms on new and used housing. An average amortization period of 15 to 20 years is common on new property, and some of these companies do not write mortgages on existing homes for longer than 15 years. The life companies' mortgage loans normally have the same term as their amortization period. However, trust and loan companies prefer to commit themselves to lend at a stated rate for only 5 years, although setting repayment schedules to amortize the loans over longer periods. They do this in

[4] For full details from 1935 to 1961 see CMHC Submission, pages 63-64.

order to obtain the right to re-negotiate the rate of interest if the cost of their funds rises sharply. In practice they are almost always prepared to renew the loan at the end of its original term and do not always call for a higher rate even if interest rates have risen in the interim. Competition has recently obliged them to offer terms longer than 5 years.

(iii) *Mortgage Prepayment Privileges*

The lending institutions stated that the borrowers' legal right to prepay mortgage loans raises difficulties for them. At present, N.H.A. loans to individuals may be repaid in full at any time after three years,[5] while under the terms of the federal Interest Act, individual conventional borrowers may repay in whole—but not in part—after five years,[6] subject in both cases to a charge of three months' interest on the amount repaid. The three year provision in the N.H.A. was a compromise struck between the government, which would have preferred complete freedom to repay, and the lending institutions, which wanted to apply the same five year rule as for conventional loans. The actual term of mortgage investments is consequently less certain than it is for bonds with prohibitions against refunding at lower rates of interest or other no-call features, and this makes them less attractive than bonds when interest rates are high. Since lenders do not have the same absolute right of calling for repayment or renegotiating the loan at a higher rate of interest, institutions such as trust and loan companies, which may have to borrow their funds at higher rates if interest rates rise, are not anxious to commit themselves to long-term mortgage loans at low yields. Thus, they have not been significant N.H.A. lenders when there has been a strong demand for conventional mortgage loans of shorter term.

The prepayment privilege given to individual mortgage borrowers—and not usually available to other long-term borrowers—may raise problems for investors. However, the principle of protecting individuals against entering into unalterable long-term commitments, or against being forced to carry mortgage loans which they may no longer need, has merit. Moreover, the difficulties for institutional investors should not be exaggerated. The institutions' concern is not so much with individual prepayments as with the average experience in their portfolios. In practice, N.H.A. loans written for 25 years have an average life of 12 to 14 years and 20 year conventional loans average 7 to 9 years. The charge levied for prepayment—which with accompanying legal fees amounts to about 3% of the sum to be repaid—and the inertia of borrowers serve to limit the amount of prepayments. Admittedly, the upward drift of mortgage rates has made refinancing unattractive at most times in recent years and substantial declines might lead to considerable refinancing. While recognizing the difficulty this might present for mortgage investors, we think it best on balance to retain the prepayment privilege. On the other hand, there seems no strong reason to maintain differing repayment rules for N.H.A. and conventional loans. If N.H.A. loans were also not repayable for five years, it would remove the slight deterrent to N.H.A. investment which the present three-year rule may impose.

Quite apart from the problems raised for lenders by changes in the cost of funds needed to finance long-term commitments, many of them are not anxious to grant loans with such long amortizations that principal repayments are extremely low in the early years. For instance on a loan yielding 6¼%, 23% of principal is repaid within 10 years if amortization is complete in 25 years: the share drops to 16% for a 30 year loan and 11% for one amortized over 35 years. Private lenders are granting some N.H.A. loans for 30 years but very few private loans have been written for the maximum 35 years permitted by the Act. The introduction of so-called "5 and 25" apartment loans is further evidence of their concern. These are 30 year loans but amortization in the first five years is at a 25 year

[5] Individual N.H.A. borrowers may prepay up to 10% of the loan at the end of the first and second years and any amount from the end of third year on. Corporate or rental borrowers may prepay the whole amount at the end of 5 years, or 10 years if the lender requires.

[6] The Interest Act does not apply to corporate borrowers.

rate, followed by 25 years at lower payments. We believe that the institutions are wise to show some resistance to the lengthening of term and that the maximum N.H.A. term should not be raised above the present 35 years.

(iv) *The Financing of New and Existing Property*

Despite the fact that competition continues to oblige the lenders to offer longer terms, a significant margin persists between the term available to N.H.A. borrowers and those who must turn to the conventional market. This margin is, however, less of a factor than the differences between N.H.A. and conventional loans in the ratio of loan to value of the property and—at times—in rates of interest. Although there is no absolute limit on the size of conventional loan most institutions can grant, they may only make first mortgage loans, and even then may not lend more than two-thirds of the appraised property value. In the case of Quebec savings banks the ratio is 60%, the law not having been changed when the ratio applying to the life insurance, trust and loan companies was raised. These ratios compare to the N.H.A. limits of 95% on the first $13,000 of value and 70% on the remainder up to the maximum loan of $14,900 or $15,600.

Thus borrowers who must obtain funds in the conventional market, whether for new or existing housing, have until recently been required to make substantially higher down payments either out of their own funds or by borrowing in the second mortgage market at higher rates of interest. In addition, the conventional rate of interest is normally higher than the N.H.A. rate. Prime conventional mortgages have at times cost borrowers virtually the same as N.H.A. funds (including the insurance fee), but the differential has been as high as 1¼%; lenders naturally charge more than the prime rate if the condition of the property, its location or the borrower's financial position justify it.

THE SUPPLY OF MORTGAGE FUNDS

The residential mortgage market centres in the lending institutions—principally life insurance, trust and loan companies, the chartered banks (when they have been active lenders) and the credit unions and savings banks. Other lenders, notably private individuals and the federal government through CMHC, are very important suppliers of mortgage funds, but their role has been to a considerable extent that of supplementary or residual lender, meeting excess demands for funds or investing in types of mortgages which the institutions are unwilling or unable to acquire.

The life insurance companies have long been the most important institutional source of residential mortgage money. As we noted in the previous chapter, there has been a continual growth in the share of life company funds invested in mortgages since the war. However, the trust and loan companies, particularly the former, have grown more rapidly—partly because their ability to bid for short and medium-term funds has been enhanced by the relatively high yields earned on their growing mortgage investments. This growth has raised their participation in the market, so that in 1960-62 they accounted for about 41% of institutional approvals compared to only 24% in the early 1950's. Yet Table 14-2 shows that in spite of the slower growth of their resources, the life companies still accounted for 56% of all residential mortgage approvals by the major institutions in 1960-62. The chartered banks became very important N.H.A. mortgage lenders in the years following the 1954 legislative amendments, but since 1959 they have originated very few mortgage loans. During the six years in which they were active, the banks approved one quarter of all residential mortgage loans by the institutions covered in the table.

As noted in earlier chapters, the mortgage policies of individual companies within each group of institutions differ widely, with some life and trust companies having large mortgage portfolios and others concentrating more of their resources on bond investments. However, there are important common features about the position of each type of institution in the mortgage market. The life insurance companies, because of the long-term and relatively low-cost funds at their dis-

TABLE 14–2

GROSS RESIDENTIAL MORTGAGE LOANS APPROVED BY LENDING INSTITUTIONS

	1951–1953		1954–1959		1960–1962	
	$ mn.	%	$ mn.	%	$ mn.	%
Life insurance companies	943.3	74.7	2,638.1	50.2	1,706.6	55.5
Trust companies	88.5	7.1	546.7	10.4	726.8	23.6
Loan companies	208.5	16.5	661.6	12.6	530.2	17.2
Chartered banks	—	—	1,292.2	24.6	1.3	—
Other[a]	22.8	1.8	114.9	2.2	111.7	3.6
TOTAL	1,263.2	100.0	5,235.5	100.0	3,076.6	100.0

CLASSIFICATION OF RESIDENTIAL MORTGAGE APPROVALS BY TYPE OF PROPERTY
1960–1962

	New Construction				Existing Property		Total	
	N.H.A.		Conventional					
	$ mn.	%	$ mn.	%	$ mn.	%	$ mn.	%
Life insurance companies	669.0	60.5	737.0	67.6	300.6	34.2	1,706.6	55.5
Trust companies	379.6	34.3	97.4	8.9	249.8	28.4	726.8	23.6
Loan companies	54.6	4.9	208.2	19.1	267.4	30.4	530.2	17.2
Chartered banks	1.3	0.1	—	—	—	—	1.3	—
Other[a]	2.1	0.2	47.7	4.4	61.8	7.0	111.7	3.6
TOTAL	1,106.6	100.0	1,090.4	100.0	879.5	100.0	3,076.6	100.0

[a]Includes Quebec Savings Banks and mutual benefit societies. Caisses populaires and credit unions are not included; in 1961 the former approved all mortgages of some $80 million and the latter not more than $15 or $20 million.

posal, have traditionally invested more freely than the trust and loan companies in new construction loans. In the years 1960-1962, 82% of the amount of life company approvals was for new construction compared to 66% for trust companies and 49% for loan companies, and the insurance companies provided 64% of all institutional funds for new residential construction. However, as already noted, the trust and loan companies have had to modify their natural preference for shorter maturities, and have offered longer terms and begun to invest more in N.H.A. mortgages. This has been particularly true of trust companies: during 1960-1962, 52% of their residential mortgage approvals were for N.H.A. loans compared to 17% in the preceding three years. A narrowing of the yield advantage in favour of conventional loans in 1960 and 1961, reflecting the greater competition in conventional lending, has contributed to this shift in the investment preferences of many trust and loan companies.

The caisses populaires are important mortgage lenders in Quebec, although they are not approved N.H.A. lenders. Because of their favourable lending rates and large membership, they account for perhaps one-third of conventional lending by financial institutions in the province. At the end of 1961 they held $348 million of mortgages, most of them secured by residential property. On the other hand, the credit unions, with their emphasis on personal loans, had only about $25 million of residential mortgages—excluding those taken as security for personal loans—with most holdings being in British Columbia, Saskatchewan and Manitoba.

Despite the greater interest in residential mortgages recently shown by some institutional lenders, and despite the appearance of new lenders in the market, the government has also been a large-scale mortgage lender. There are a number of reasons for this situation. Part of the imbalance in the private market results from the fact that the lending institutions do not have facilities in every community to make funds available on regular N.H.A. terms. It is probable that under any arrangements there would be some mortgage demand of this sort which the government would wish to meet. However, present arrangements have inflated the call on government funds well beyond such special situations. In fact, CMHC has for some years provided funds throughout the country, not because private lenders lack the facilities, but because they are either prevented from N.H.A. lending or have inadequate incentive to do so at going rates on such mortgages.

For some years after the amendment to their legislation in 1954, the chartered banks were substantial suppliers of mortgage funds. Through their extensive branch systems, they were able to lend in smaller communities not fully served by other lenders and to supplement the flow of funds from other institutions in all parts of the country. In those years, private lending handled all but a small part of the mortgage demand. Since mid-1959 however, the banks have all but withdrawn from N.HA. lending—partly because of other demands upon them and partly because of doubts about the propriety of making direct mortgage loans above 6%. In addition, there have been occasions when the N.H.A. rate was fixed at levels which were unattractive to lenders, given alternative rates on conventional loans and on securities. Thus the government's policies have resulted in a gap in the availability of funds which it felt obliged to fill with direct CMHC lending. From 1957 to 1962, CMHC approved loans of $1.6 billion and at the end of 1962 its portfolio was almost $1.3 billion.[7] In the same years, the private institutions approved $2.6 billion of N.H.A. loans, bringing their combined portfolios at the end of 1962 to $3 billion.

The market in mortgages on existing properties is much more complex and fragmented than that on new housing: the quality of security is less uniform, the terms and conditions of borrowing vary more widely and there are a great many more lenders. In the new housing market, there are some 65 institutions approved to lend under the N.H.A. Although the number making conventional mortgages on new houses is considerably larger—including as it does the caisses populaires, some credit unions and other financial institutions not entitled to originate N.H.A. mortgages—the participants are still relatively few, the lenders are mainly institutional and the terms of lending remain relatively uniform. In the financing of existing properties, in contrast, individual lenders play a major role and terms vary widely. Moreover, because of the limits under which the main institutional lenders operate, other institutions not subject to the same restrictions have emerged to develop what amounts to a supplementary mortgage business. The need for such additional supply is increased by the fact that neither the chartered banks nor CMHC is empowered to lend in this part of the market. Some banks are, however, entering the field indirectly through associated companies.

Even when one of the major institutions is prepared to take a first mortgage, the buyer is faced with putting up cash for at least one-third of the appraised value of the property out of his own funds or with financing obtained from some other source. When additional financing of some sort is required, the most common solution is for the seller to accept part payment in the form of a second mortgage, and much residential mortgage investment by individuals arises in this way. However, many sellers of houses and other individuals do acquire first or second mortgages as the result of a conscious investment decision. Mortgages are convenient, high-yielding investments for many people, particularly in small communities where both the property and borrower are known to the lender and where alterna-

[7] Joint loans and insured loans to builders and home owners only. Uninsured loans accounted for a further $300 million.

tive investment opportunities are not as great as in larger centres.

Statistical information is sketchy, but estimates prepared by CMHC show total mortgage holdings of individuals, unincorporated businesses and charitable institutions amounting to about $3.5 billion in 1961, and personal holdings would account for a large part of this total. In our own survey of consumer finances, about 6% of households reported holding mortgage and miscellaneous loans; the average amount for all households in the survey was just over $600. Assuming that most of these loans were mortgages, and that our survey is representative, the national total would be of the order of $2¼ billion. The average amount held per household rises with the age of the head of the household, being largest where the head was over 65 and was more likely to have taken back a mortgage on a previous sale of a house. Mortgage and other loans accounted for about 15% of the average holdings of financial assets of all households in the survey, compared to about 12% for marketable bonds and close to 25% for shares. It would be helpful if the authorities could obtain further data on the amounts, terms and costs of mortgages held outside the main financial institutions, since knowledge of this important sector of the mortgage market is now very limited.

In addition to mortgage lending by individuals, a great variety of businesses large and small invest in first mortgages of up to 80% or more of residential property values. These lenders also make second mortgage loans, either to facilitate the sale of houses by reducing the gap between the property value and the 66⅔% which the major lenders are permitted to advance, or to provide homeowners with funds for other purposes. The 80%-85% mortgages are a recent development in mortgage finance, and a number of companies have been set up in the last decade, and particularly in more recent years, to specialize in this business. Some of them raise funds directly in the securities markets by means of a variety of short and long-term debt issues as well as equity issues, while others are subsidiaries or affiliates of the larger finance companies; the latter reflect the pattern of investment diversification which has marked that industry during the past decade and which was discussed in Chapter 11.

In some cases these companies put up all the funds themselves, while in others arrangements have been made for joint lending with the regulated institutions. For example, a trust company will take a first mortgage equal to 66⅔% of the value, leaving the supplementary mortgage company a second mortgage on a further 16⅔% on which a higher return is obtained. Such arrangements are simply a technique for blending two mortgages in a single loan covering a high proportion of the property value. The combined rate of interest varied from 8% to 10% when conventional first mortgage rates were 7% to 7¼%, but with increased competition this rate is now commonly lower.[8] Separate second mortgages are usually written by the specialized lenders for five, ten or 15 years, whereas under the blended loan technique the full 80% may be amortized over periods of as long as 25 years.

The introduction of high-ratio lending by substantial institutions, some of them having facilities to operate in a number of provinces, has tended both to lengthen the term and reduce the rate of second mortgage lending. A second mortgage of longer than five years is no longer a rarity, and rates in urban centres are typically around 12% compared to the 20% or more which was common a few years ago. However, there is still a certain amount of high-rate lending by some fringe institutions and by individuals or groups of investors familiar with real estate. This remains an area of the financial system in which unscrupulous operators are able to exact usurious terms from some borrowers—frequently from people newly arrived in the country. We are pleased that steps have been taken by provincial governments to ensure that fraudulent or unconscionable transactions are controlled, but the best

[8] For instance, a 7½% combined rate on an 80% mortgage when the first mortgage is written at 7% implies a rate of about 9½% on the top portion of the loan.

support possible for such efforts is to have full disclosure of effective rates of interest and to make funds available through legitimate lending institutions at economic rates of interest.

REGIONAL DIFFERENCES IN THE MARKET

Despite the lengthening term of conventional loans and the appearance of new lenders making high-ratio loans, there remain significant differences in the financing of new and existing housing. There are also important regional differences in the structure of the market. For instance, conditions vary substantially with the age of the housing and thus, typically, its location. In his evidence before us, Mr. Mansur generalized the situation in the cities by referring to three types of housing; that in the post-war sub-divisions, a second band built in the interwar years in residential areas and varying considerably in its current quality and state of repair, and a third category of older housing situated in the centre of the cities.[9] The established mortgage institutions will lend freely in the first area at their prime rates, are prepared to lend on much of the second type of housing, although at rates which may be as much as 1% higher, but are not interested in acquiring mortgages on the older run-down urban properties in areas which may be due to undergo considerable change. Such loans are typically made by private or other investors at rates in the range of 10% for first mortgages and considerably more for second mortgages. Although there are undoubtedly occasions when an institution's own guide lines lead it to reject quite sound mortgage propositions, some broad policy decisions are essential in their business and those described by Mr. Mansur are neither surprising nor unreasonable. However, these preferences on the part of the principal institutions do mean that the problem of financing housing sales is more acute in some parts of our cities than in others.

There are also important regional differences in the character of the mortgage market. The main lending institutions acquire mortgages in most parts of the country, either directly through their own branch organizations or from agents operating in centres where they do not have facilities. However, a high proportion of their mortgage funds is placed in the larger cities and towns while they play a relatively less active role in smaller communities. Thus, while the institutions financed 69% of all N.H.A. housing starts in 1962, their share was 77% in metropolitan areas, 60% in major urban areas and only 44% in all other parts of the country.[10] Some of these differences may stem from the relatively greater willingness of individuals in smaller centres to invest in mortgages, and indeed some institutional lenders told us their agents had difficulty in locating good mortgages in such centres. However, the fact that CMHC was called upon to lend much more heavily in the areas outside main cities suggests that this is not the complete explanation. It is interesting to note that in 1958, when the chartered banks were active in N.H.A. lending, the discrepancies in institutional lending by size of centre were less marked: private institutions financed 57% of N.H.A. housing starts in metropolitan areas, 50% in major urban areas and a slightly higher share, 53%, in other areas.

Smaller regional differences are found in the conventional mortgage market, but here they are reflected in differences in the cost as well as the availability of funds. Thus in 1962 the average yield on all mortgages registered varied from 6.93% in Quebec to 7.74% in Prince Edward Island, with rates tending to be higher in the Atlantic Provinces than in other parts of the country.[11] Borrowers in Quebec enjoy low rates largely because of the activity of the caisses populaires: since they lend in all parts of the province, they reduce the regional differences within Quebec as well as keeping rates low relative to other parts of the country. In Ontario, the loan and trust companies have a similar impact although their branches are not as numerous or widely dispersed as are the caisses populaires.

[9] See evidence of Mr. D. B. Mansur, Transcript pages 6128 ff. These categories apply particularly to larger cities.

[10] *Canadian Housing Statistics, 1962*, Table 32.

[11] *Canadian Housing Statistics, 1962*, Table 50.

MORTGAGE INSURANCE FOR EXISTING PROPERTIES

The difference between the terms on which new and existing housing may be financed results both from the availability of a government guarantee on mortgages for new housing, which is not applicable to those on existing property, and from the limitations imposed on the loan to value ratios of the major lending institutions. Moreover, the main object of government housing policy has been to increase new residential construction. This element of discrimination has served its purpose well, for those with limited savings have found it easier to build or buy new properties than to buy existing housing.[12]

More equal financing terms in the two parts of the housing market would all but certainly contribute to a more balanced and rational use of the housing stock and more economic rates of increase, transfer and improvement. However, it would be foolish to assume that such improvements would necessarily check the flight to the suburbs or lead to the restoration of urban slum areas, which owe their existence to deep-seated social and economic factors. Experience in the United States, where government guarantees extend to existing houses, indicates that better financing terms on older housing may have little effect on urban development and that as long as people wish to buy their own separate housing, sheer space considerations will force an outward move from the centre of the city.

It has been suggested that government guarantees be extended to mortgages on existing housing to reduce the disparities between the financing of such property and new construction. Assuming that the technical difficulties of providing guarantees for loans secured by the great variety of existing houses could be overcome, (lending ratios, amortization periods, and other terms would clearly have to vary with the state of repair and prospective market values of individual properties) the results of such a change cannot be foreseen. It would almost certainly increase demand and prices for existing housing, both absolutely and relative to new housing. These price increases might offset some of the initial decline in new housing demand which could result from a re-shuffling of the ownership of the housing stock. How extensive this re-shuffling would be is impossible to guess—many families prefer to live in downtown areas for economic and social reasons, and changed financing terms would not affect their decisions. Similarly, many older people living in houses now bigger than their family needs require would not necessarily move just because improved financing enabled them to realize more for their house, especially if the surplus space is rented to others as is frequently the case.

Nevertheless, there would undoubtedly be important changes in the lenders' willingness to finance used properties—depending on the rates and other lending terms relative to those available on new construction. The effects of this increased lending on the financing of new housing and on the funds available elsewhere in the capital market would, of course, depend on what the recipients of the extra financing—and former mortgage lenders displaced by the institutions—do with their surplus funds. Because of these various unknown factors it is not possible to form a clear view of the results of extending government guarantees to existing housing.[13]

The evidence placed before us, including that from CMHC[14] and our own studies, does not argue the need for so radical and difficult an innovation, although improvements in the conventional mortgage market can and should be made by bringing in new lenders—notably the chartered banks—and expanding the permitted terms of conventional lending by the financial institutions. If such important changes were made, we would expect a closer and more desirable balancing of

[12] It can be argued that the steady increases in the prices of much existing housing do not suggest that mortgage arrangements have made it excessively difficult to find buyers. However, the rising values often result in part from the demand for land for alternative uses as the cities expand and develop.

[13] We would not be concerned over the supposed danger of "monetizing the housing stock" by improving its marketability. There is no reason to believe that the community would begin liquidating its holdings to spend on other goods and services —a "flight from housing" seems highly improbable.

[14] Transcript, page 6084.

new and used residential financing terms to come about without the need for direct government intervention. Another innovation which might carry the evolution of the market forward would be the provision of private mortgage insurance on conventional loans. Such insurance is available in the United States and one company has recently been established to do a similar business in this country.[15]

THE SECONDARY MARKET

In recent years, both the government and private interests have attempted to broaden the mortgage market by attracting new private lenders. CMHC has attempted to promote the development of a secondary market for the trading of N.H.A. mortgages so that investors who do not have the facilities to originate mortgages or to service them, as well as those needing some means of liquidating assets from time to time, may be induced to invest in them. Private N.H.A. lenders have not bought and sold outstanding mortgages on any substantial scale under the provisions of the 1954 Act permitting approved lenders to sell loans provided they continue to service them. From 1954 to 1962, the institutions sold $318 million of mortgages from their portfolios, with the chartered banks accounting for $164 million. In 1962, institutional sales, which include substantial transactions between originating lenders and affiliated pension funds rather than being true secondary market sales, were about 2% of the institutions' mortgage holdings. Thus the 'turnover' of N.H.A. mortgages is well below that of alternative investments such as bonds[16] and stocks.

The main buyers of existing N.H.A. mortgages—other than those sold by CMHC—have been those life insurance companies which do not originate loans themselves and pension funds, particularly those of the federal crown corporations and those for employees of the selling institutions.[17] Some other corporations, and even individuals, were also brought into mortgage investment in this way. Further steps to broaden the secondary market were taken in 1961 by CMHC, which began the practice of selling mortgages out of its own portfolio at auctions open to approved N.H.A. lenders and members of the Investment Dealers' Association. To the end of 1963, $209.5 million of mortgages had been offered in seven auctions and $148 million were sold.[18] The main buyers have been banks and trust companies, which purchased $70 million and $48 million respectively, although not principally for their own accounts; investment dealers purchased $15 million, life companies $8½ million and others $6½ million.

Investors wishing to participate in these auctions bid for parcels of mortgages prepared by the Corporation, which does not bind itself to accept bids on all the parcels offered. The auctions are a useful initiative, but experience with them has been limited and they have not yet attracted many new mortgage investors. The Corporation is considering the possibility of continually standing prepared to sell mortgages at posted prices, a technique which would more easily enable it to give buyers options for a period of time so that they may examine the mortgages and the properties concerned.

Among the ultimate buyers of mortgages sold at these auctions have been recently-established financial institutions set up to specialize in N.H.A. mortgages. These institutions finance their portfolios by bank borrowings and sales of short-term paper and debentures in the securities markets. Many people familiar with the mortgage market have felt that such corporations, which are simply specialized loan companies, afford the best means of attracting additional investment funds for mort-

[15] In general terms, such companies insure mortgages in return for a fee. In Canada, the portion of high-ratio loans above the presently-permitted 66⅔% of property value would have to be assumed by investors not regulated by the legislation relating to life, trust and loan companies.

[16] See Chapter 16.

[17] $137 million of the $229 million of N.H.A. mortgages held by trusteed pension funds in 1961 were in the funds of government agencies and federal crown corporations.

[18] One offer was withdrawn because a sudden change in monetary policy drastically altered the state of markets at the time of the auction.

gages from individual investors.[19] These companies may ultimately extend their operations into the field of conventional mortgages, in which the lack of uniformity and insurance pose even more difficult problems of trading the underlying instruments themselves. Somewhat similar in nature are the mortgage funds of a number of trust companies in which the holder may buy units of participation. The American technique of selling participation units in individual apartment or other buildings is not frequently seen in Canada.

Even if some of the legal and technical difficulties of investing in and transferring mortgages could be overcome,[20] mortgages will doubtless remain less attractive than alternative long-term investments for most individuals' portfolios, and various institutional lenders will thus continue to constitute the market for these obligations. However, means of improving the secondary market should not be neglected. For example, we see much merit in the suggestion put to us that CMHC improve the appeal of its auctions by making more information available on the mortgages included in its parcels.[21]

In addition, we have had representations that the Corporation could increase the willingness of financial institutions to hold N.H.A. loans by standing prepared to discount them—presumably at a penalty rate—in order to provide temporary access to cash for dealers and institutional holders of mortgages. Legal provision for such operations now exists, and we believe that the government should not wait for some difficulty to arise before making arrangements for the Corporation to use these powers if they should become necessary.[22] This facility should only be available on a temporary basis and at penalty rates to tide an institution over a short-term liquidity difficulty and might, indeed, be used little if at all. At the same time, care must be taken to ensure that monetary policy considerations are given due weight in formulating CMHC policy; this should not be difficult as the Department of Finance and the Bank of Canada do in fact participate in discussions about the secondary market.[23]

[19] See Transcript page 6106 for views of the President of CMHC.

[20] See submission of John R. Campbell, which refers to legal difficulties in connection with the acceptability of titles, foreclosure proceedings and some features of the insurance provisions.

[21] Transcript, page 6202 (evidence of Mr. Mansur).

[22] See Transcript pages 6110-6112 for a discussion of this matter with CMHC.

MORTGAGE RATES AND STABILIZATION POLICY

The demand for housing is affected by changes in interest rates and other loan terms in the mortgage market. However, spending on housing is perhaps more importantly influenced by the availability of mortgage funds from private lenders. In addition to these reactions in the private financial market to changes in credit conditions, including changes in the administered N.H.A. rate, house building has been strongly influenced on occasion by direct government action to vary the flow of mortgage funds supplied by CMHC. Although many other factors influence housing demand, significant patterns linking financial developments with housing expenditure can be traced. This is not surprising in view of the heavy dependence of house building on borrowed funds.

The evidence of the effects of changes in mortgage borrowing terms on the demand for housing finance is not easy to interpret because of the major changes which have occurred simultaneously on the supply side of the mortgage market. Our consumer survey included some hypothetical questions bearing on the point, and the results indicate that a significant share of spending on housing would be reduced or deferred by substantially tighter mortgage terms. On the other hand, the survey suggests that the decisions of potential home buyers are less likely to be influenced towards larger expenditures by easier mortgage terms.[24]

The changes in mortgage terms assumed in the questions in our survey are substantial, although comparable changes did occur in the prime conventional lending rate between 1955 and 1957. As shown in Chart 14-1, however, conventional

[23] Transcript, pages 6100-01.

[24] See Chapter 21 for a further discussion.

THE MORTGAGE MARKET

Chart 14-1
MORTGAGE AND BOND RATES

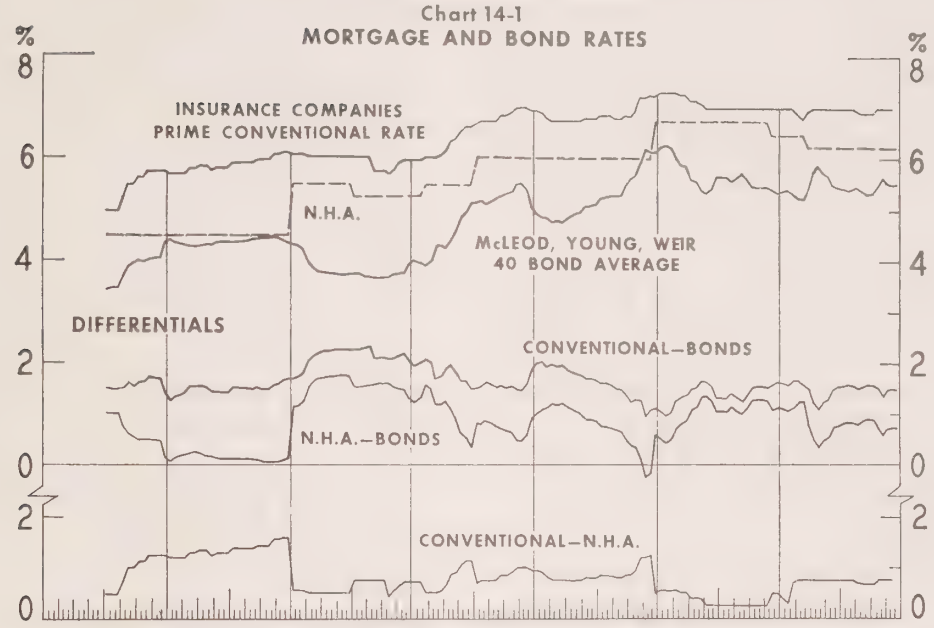


Chart 14-2
GROSS MORTGAGE APPROVALS BY LENDING INSTITUTIONS AND C.M.H.C.

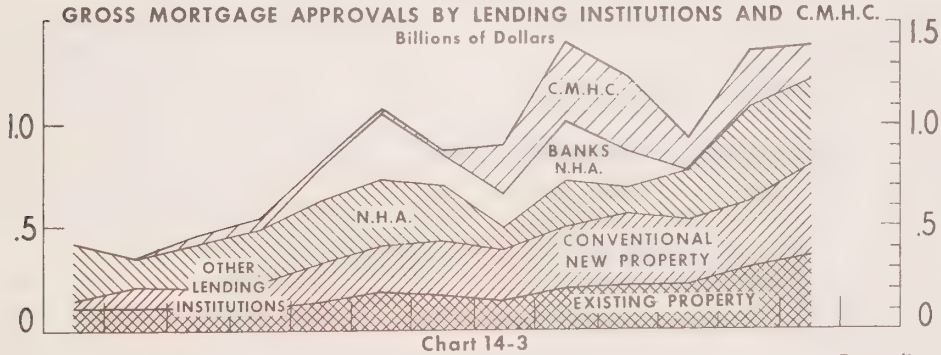
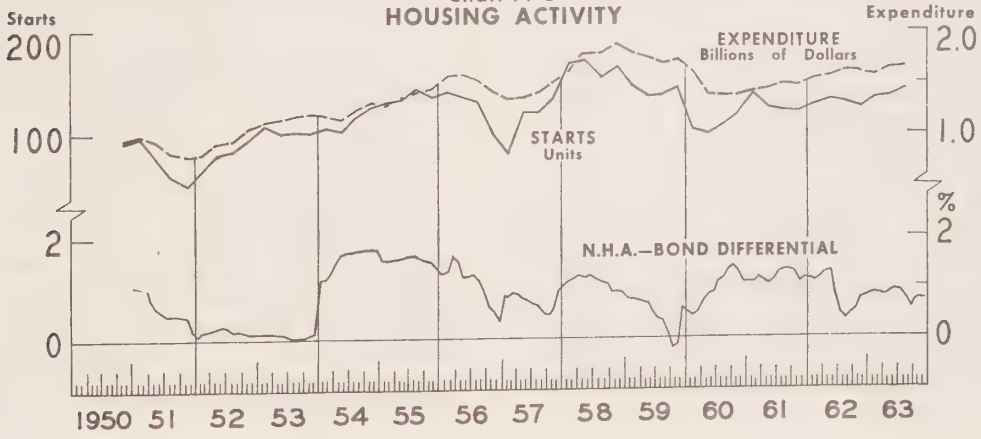


Chart 14-3
HOUSING ACTIVITY



mortgage rates have generally been considerably less flexible than the yield on market bonds, while N.H.A. rates have varied even less. So far as conventional loans are concerned, it is undoubtedly true that other features of loan terms have also varied. Moreover, the willingness of institutions to lend at the prime rate shown in the chart, rather than at higher rates, has altered over credit cycles; the prime rate series thus understates the effective changes in mortgage credit conditions. In their evidence before us, spokesmen for the trust and loan companies said that when money is tight they tend to cut back on the size of loans relative to property value and that at such times the size of loan can be a more important factor in competition than the rate.[25]

There is no question that substantial changes in these other mortgage terms can significantly affect the demand for funds and new housing. For instance, the increases in down payments required under the N.H.A. in February 1951 were a major factor in the decline in institutional approvals of new construction loans from $310 million to $237 million and the reduction in housing starts from 92,531 in 1950 to 68,579 in the following year. Similarly, the increases in loan to value ratios made in 1954, 1957 and 1960 have stimulated the demand for housing. The evidence put before us suggests that such changes affecting down payments and the amounts of monthly payments have a greater impact on borrowing and house building decisions than interest rate changes. For instance our survey of consumers—on which we would not place too much reliance—indicates that borrowers appear to be more sharply affected by interest rate increases when they are reflected in higher monthly payments than when the term of the loan is lengthened sufficiently to keep monthly payments unchanged. The survey does not give good evidence on the effect of changing down payments but it is clear from the fact that borrowers are unwilling to shift to conventional loans with higher down payments when N.H.A. funds are unavailable that this factor is of major importance.

[25] Transcript, page 5852.

Finally, we may note that our own econometric results—while admittedly not exhaustive—failed to find a relationship between interest rates and the demand for new housing. On the other hand, one reason that the institutions give for rationing funds in periods of strong demand rather than raising lending rates more sharply than they do is a fear that too many potential mortgage borrowers would be deterred by higher rates.[26]

The relative stickiness of mortgage interest rates undoubtedly reduces and delays the effect of a change in general credit conditions on housing demand. It reflects basic differences between the residential mortgage market and the bond market. The fact that loan commitments on new housing—whether the original borrower is a builder or the home owner—are entered into some months before funds are actually disbursed leads to stability of rates, particularly when market rates are rising. Frequent adjustments of their rates would annoy home owners and, even more importantly, the house builders on whom lending institutions rely for a good deal of their business. Moreover, very frequent changes in rates and lending policy would tend to disrupt the whole lending organization. Like those of the chartered banks, the loans of these institutions originate mainly at the local level, and a continuing stream of differing head office directives is not consistent with maintaining an effective and competitive branch system.

Another factor which explains the comparative slowness to change of mortgage rates is that the vast majority of mortgages are bought to be held to maturity by the original lenders. Since there is very little trade in outstanding mortgages, the mortgage market—unlike that in bonds and stocks—does not have a forum in which prices are continually adjusted to shifting demand and supply pressures from buyers or sellers anxious to take advantage of very small yield differentials. Finally, one vitally important mortgage rate, that on N.H.A. loans, is set by the government and has not been adjusted sensitively to changes

[26] See for instance Transcript pages 5876, 5882, 5886.

in market rates, so that relatively rigid rates have been imposed on a crucial part of the market. Although there is evidence of some shortening in the lag between changes in bond yields and mortgage rates, the market is still not immediately sensitive to changes in the financial climate.[27]

Whatever may be the influence of changing loan terms on people's willingness to incur mortgage debt, there is no doubt that changes in the supply of mortgage credit have had an important impact on residential construction. These have not resulted primarily from changes in the availability of funds to mortgage institutions, but from artificial rigidities in the interest rate structure. We have seen in earlier chapters how the growth of life companies' funds is not greatly affected by changing credit conditions. This is not true of the trust and loan companies, but they have chosen to run off part of their security holdings in order to acquire mortgages when their total funds have failed to grow or declined. Moreover, when there is upward pressure on interest rates, as in 1956-57 and in 1959, conventional mortgage rates tend to rise, although less abruptly than some other long-term rates, and the volume of such lending increases.

On the other hand, the government has frequently chosen not to allow the full upward movement in interest rates to be reflected in the maximum rate on N.H.A. mortgages, and insured mortgages on new buildings thus tend to lose their attractiveness as investments to the lending institutions. For example, from late 1955 to late 1956 the N.H.A. rate rose by only .25% while yields on prime conventional mortgages rose .7% and bond yields rose about 1¼%. Similarly, in the year ending in November 1959 the N.H.A. rate was unchanged while conventional rates rose about half of one percent towards the end of the period and average bond yields rose a full percent. Not surprisingly, the lending institutions find N.H.A. mortgages unattractive in these circumstances. The close relationship between these interest rate changes and fluctuations in the flow of N.H.A. funds from the institutions is shown in the charts. From 1955 to 1957, N.H.A. approvals by the life companies fell from $227 million to $96 million, while those of loan and trust companies dropped from $42 million to $9 million. In 1959, life company N.H.A. approvals of $113 million were $58 million below the previous year, and there was again a sharp drop in N.H.A. lending by the trust and loan companies.

Not all of the funds diverted from investment in N.H.A. loans are lost to the new housing market, because the lending institutions are able to raise rates on new conventional loans and are thus willing to increase their investments in such mortgages. For example, their new residential conventional loans were $20 million higher in 1956 than in 1955, and rose $52 million from 1958 to 1959. However, increased conventional lending, which has been more regular year by year than the flow of money into N.H.A. mortgages, has not been sufficient to offset the drying up of private N.H.A. funds. Borrowers are unwilling or unable to meet the higher down payments and monthly payments of conventional loans. Thus, the demand for, and rates on, such loans are not sufficiently high to prevent the total amount of new residential lending by the institutions from dropping sharply when the N.H.A. rate becomes unattractive.

In late 1959, the supply of funds was further cut by the change in the chartered banks' position. An N.H.A. rate of 6.75%, which was not high enough to draw funds from other institutions in competition with other calls on their resources, was nonetheless too high for the banks since it exceeded the 6% ceiling on their lending rates. Although views on the legal position differ, and although the banks may buy outstanding N.H.A. mortgages and other investments yielding more than 6%, it was indicated to them that it would be undesirable if they acquired new N.H.A. mortgages at more than 6%. In these circumstances, it would have proved impossible to ration the flood of applications at more than ¼ of 1% below the true market rate, and indeed would have

[27] See Chart 14-1.

made little sense to do so in view of the lower servicing costs of commercial loans at the same rate. This situation, combined with strong pressure on their liquidity, led to the banks' virtually complete withdrawal from N.H.A. lending. Their approvals fell precipitously from $300 million in 1958 to $175 million in 1959 and to only $1 million in the following year.

Against the background of these violent fluctuations in the private supply of new housing finance shown in Chart 14-2, the government itself has played a changeable role. In 1957, the drop of $147 million in private N.H.A. approvals from the 1956 level was more than offset by an increase of $215 million in direct CMHC lending. In 1959, CMHC lending was maintained close to the 1958 level, but in the following year, when private lending again fell as a result of the change in the chartered banks' position, CMHC was instructed by the government to cut back its lending by $150 million because of concern over the government's cash position and belated—and as it turned out, misplaced—concern over inflationary pressures. In fact, the Corporation's approvals declined from $367 million in 1959 to $168 million in 1960. Housing starts fell from 141,345 to 108,858, most of the decline being accounted for by reduced CMHC lending. The policy was carried out by a process of rationing and a decision not to lend to home owners with incomes over $5,000.[28]

By manipulating the N.H.A. rate and altering CMHC lending, the government can clearly exert a powerful influence on the supply of mortgage funds and, with some delay, on spending on new housing. (The cyclical behaviour of housing starts and new housing expenditures are shown in Chart 14-3.) Because of the heavy use of labour in the construction industry, measures to affect house building can be an important component in stabilization policy. Whether or not the N.H.A. rate has been deliberately used for stabilization purposes—and it has been suggested to us that developments in 1956-57 and 1959 were not always consciously sought[29]—the mechanism did at times operate to assist in the task of stabilizing the economy. At other times, however, direct government lending policy was destabilizing; for example, its curtailment in 1960 was hardly appropriate to the weakening economic circumstances of that time.

It should also be stressed that the circumstances of the 1950's particularly favoured this instrument of policy. In the face of strong demand for housing, it was possible to restrain activity in some years in confidence that when funds were made available again house building would rebound quickly. Now that the most pressing demands for housing have been met, at least temporarily, it is uncertain that the tap can still be turned on and off quite as decisively.[30] This is particularly true because the series of reductions in down payments has brought them close to the practical minimum, and there is thus little room for stimulating demand in this way. Moreover, some disadvantages follow from the irregular flow of N.H.A. funds, for the periodic disruption of the residential construction industry makes it difficult to increase efficiency and reduce costs through the establishment of large and relatively stable enterprises.

While we do not believe that housebuilding should be shielded from the effects of government policy, we think it unnecessary and undesirable to concentrate too much of the impact of counter-cyclical measures on this one sector of the economy. If other instruments of policy are used appropriately, it should not prove necessary to do so, although we would not wish to preclude the government from taking strong action in this or any other part of the economy in emergency circumstances.

RECOMMENDATIONS FOR THE MORTGAGE MARKET

Our review of the mortgage market has persuaded us that changes should be made in the

[28] For detailed changes in CMHC's lending policy, see its Submission, paragraphs 3-11 and 3-12.

[29] See Transcript, pages 6078, 6088.

[30] See Transcript, pages 6059-60 for the views of CMHC on this question.

present arrangements under which government policy and legislation lead to substantial limitations in the supply of private mortgage funds and which contribute to the extra difficulties of mortgaging existing properties.

In our view, much of the imbalance in the mortgage market for new housing would be overcome if the N.H.A. rate were free to move with market forces and allowed in normal circumstances to find its own place in the broad pattern of interest rates. This rate is presently set by the Cabinet, which is often slow to alter it in times of rising general interest rates, and has an understandable reluctance to make the full adjustments necessary. When general credit conditions are easing, on the other hand, there is a temptation to move the N.H.A. rate down faster and further than circumstances justify. In either event, as we have seen, the inadequate return on N.H.A. lending forces the government to be a heavy direct lender or means that many borrowers either are unable to obtain funds or are driven into the higher-cost conventional or supplementary mortgage markets. If the N.H.A. rate were freed, in contrast, it would tend to move up and down with other long-term interest rates, and be a more accurate reflection of the price at which mortgage business on new housing was actually being done.

The best approach would be for the maximum on N.H.A. rates to home owners to be set automatically at a margin, say, 1½% above average rates on long-term Government of Canada bonds.[31] The maximum would provide a limit on the yield at which the Government was prepared to guarantee private mortgage lending, but we would expect N.H.A. rates to be set by the market below the maximum. (Indeed if market forces were to drive rates to the maximum this would mean that the system we envisage was not working and that the maximum was too low.) An alternative approach would be for the Government to vary the maximum rate administratively in line with changes in other rates, but to alter the rate regularly, perhaps once every quarter if market changes call for an adjustment. It would perhaps be easier under this system to use N.H.A. rate adjustments for purposes of economic stabilization, but it has the disadvantage of the present system that the rate may remain at inappropriate levels because of the Government's failure to act. Either method would be preferable to the present situation but we think the first approach has more to commend it.

Since a free rate would be competitive with other rates at which private lenders could invest their funds, it would avoid the sudden gyrations in the availability of private N.H.A. mortgages which have characterized the market since the mid-1950's. Since it thus would not necessitate massive CMHC lending, it would also avoid some of the instability connected with changes in government direct lending policy. Finally, a rate free to move up and down more flexibly would have an increased, although still moderate, dampening or stimulating effect on the demand for mortgage finance. It would thus make some contribution to stabilization policy as a partial offset to the reduced impact of changes in the supply of N.H.A. funds.

Under a free rate, some slight regional differences in N.H.A. mortgage costs might develop, reflecting the stronger demand for housing in some areas of the country than in others. We would not expect this to be significant since most lending is done by national organizations which find it easier to lend at uniform rates across the country. If, however, large or undesirable differentials should develop because of the unwillingness or inability of lenders to service certain outlying communities, we see no reason why CMHC should not step into such markets as a lender of last resort—the role originally intended for CMHC residual lending to home owners.[32]

If the objectives of general economic policy were to call for the restraint or stimulation of house building beyond that which could be

[31] Rates on other types of CMHC lending—e.g. for slum clearance—could continue to be set administratively.

[32] Regardless of the extent of regional differentials permitted, lenders should be allowed to originate N.H.A. mortgage loans at small discounts or premiums under a free rate system. This would permit them to vary effective rates closely while maintaining convenient coupon intervals of, say ¼ of 1%. Large discounts, however, should not be allowed because they can seriously affect the borrower's down payment.

achieved through changes in market rates of interest, the government could always achieve its purposes by varying the other terms of N.H.A. loans from time to time. As already noted, although down payment ratios are now at very low levels, there is no reason why these ratios should not be raised if demand pressures again become excessive. We would prefer to see major changes of this kind reserved for fairly extreme circumstances since it is our view that house building should not be made subject to major variations each time there is a modest change in the general economic environment.

Regardless of how variations in the terms of N.H.A. lending are used, however, stabilizing policy should be operated explicitly rather than relying on the adventitious effects of an inflexible rate on the supply of funds. As we have seen, these effects are in fact frequently destabilizing. Although unpopular decisions will at times be necessary, the government should be prepared to make them openly and deliberately. The government should take whatever steps it considers necessary in emergency conditions, including the deliberate fixing of the N.H.A. rate at a level which dries up the supply of funds. Stabilization policy could also be supported by appropriate timing of expenditure on public housing, for there are substantial needs for slum clearance, subsidized housing and similar projects which private interests cannot be expected to meet. In the 1952-61 period, just over 2% of all new housing expenditure was accounted for by joint federal-provincial housing projects and limited-dividend housing corporations, the two main forms of housing for low-income groups. CMHC also told us that only 8,000 of the 1½ million housing units built since the war have been subsidized for low-income housing groups.[33] While such groups have benefited to some extent from the "filtering down" of housing from those who obtained new N.H.A. loans, there seems to be considerable scope for further outlays, which could to some extent be tied into stabilization policy.

[33] Transcript, page 6045.

In addition to freeing the N.H.A. rate, the private supply of N.H.A. funds for unsubsidized housing could be increased by bringing more lenders into the market. It is most unfortunate that the interest rate ceiling and other factors have obliged the chartered banks to withdraw from lending since 1959. From 1954 to 1959, the banks showed themselves able to operate effectively in this market, both in the large cities and in smaller communities where many other lenders are not active. In those years, they provided a flow of funds roughly equal to that which CMHC has advanced in direct loans since the banks withdrew from the field. Although the banks, like other lenders, would vary the flow of investment in mortgages depending on rates of return and their available resources, we would not expect them to enter the market and withdraw suddenly, provided that they are free to move their rates. Having established themselves in the mortgage market they will not wish to disrupt their relationships with builders and borrowers by following excessively variable lending policies. Our recommendations about the interest rate ceiling will be fully discussed in Chapter 18, but an important consideration in the matter is to ensure that the advantages of the banks' large branch system to the mortgage market should not be needlessly lost.

It would also be desirable to increase the number of approved N.H.A. lenders by admitting those caisses populaires and credit unions which wish to participate, and have the facilities to do so efficiently. While they have not so far expressed any great interest in moving into this field, they might well do so if the rate were set by the market in appropriate relationship to conventional rates. Whatever success can be achieved in developing the secondary market in mortgages will also serve to increase the supply of funds, and we therefore urge CMHC to continue to improve and extend its auctions, to assist private institutions in every way possible to develop sound new mortgage facilities and to establish discount privileges at penalty rates for approved private lenders.

Judging by our earlier experience and by that in the United States—where the effective Federal

Housing Administration rate fluctuates with other market rates and the Administration does not need to be a net lender to the mortgage market over time—these changes should enable CMHC to withdraw from the massive residual lending operations it has undertaken in recent years. The Corporation could then concentrate on specialized lending operations for purposes which cannot be expected to attract private funds, on acting as a genuine lender of last resort to the market and on the tasks of working for continued improvements throughout the mortgage market and of advising the government on housing policy. Such a transition would involve a substantial reduction in the government's need for funds which would release savings flows for the purchase of assets other than government securities. One means by which government might smooth this transition would be to press the sale of Canada Savings Bonds less vigorously. The latter probably compete more closely than marketable securities for the funds which might otherwise flow to trust and loan companies, banks, life companies and other mortgage institutions. To the extent that competition from C.S.B.'s has this effect, it can be argued that it has diverted funds from private mortgage lending and increased the need for direct lending by CMHC.[34]

The changes suggested for the N.H.A. market should go some way toward solving the problem of the financing of existing housing since they will prevent the emergence of wide differentials between the interest costs of financing new construction and existing properties. The N.H.A. rate would presumably settle below the prime conventional rate by a margin representing the value of insurance, perhaps ½% to ¾% depending on market factors, and we would not again have situations in which the conventional rate is as much as 1½% higher. However, we feel more direct measures are necessary to eliminate undesirable deficiencies which might still remain in the amount and terms of funds available for financing existing housing.

Having considered the matter carefully, we believe that the chartered banks, like other institutions doing essentially a banking business, should be permitted to invest in conventional as well as insured mortgages. The present anachronistic prohibition impedes the flow of long-term savings into the mortgage market to the detriment of both mortgage borrowers and the banks' deposit customers and shareholders. In view of the substantial changes which have occurred in the mortgage market in the last generation —in particular the general acceptance of regular amortization schedules—this prohibition no longer seems necessary for the protection of bank funds and should be removed. The broader implications of this proposal will be discussed in Chapters 18 and 19, but if it were carried out the Home Improvement Loans guarantee could also be removed. This legislation, which was introduced to enable banks to take mortgage security on loans for property improvement (up to a maximum which is now $4,000) despite the existing prohibition in the Bank Act, would then become redundant since the banks would be free to make such loans without special authorization. The guarantee itself is no longer important: losses have been small and the banks are now thoroughly familiar with the business.

Lending terms in the two parts of the mortgage market could also be brought closer together by raising the maximum loan to value ratios imposed on some of the major lending institutions. These ratios do not now apply to lenders such as the caisses populaires, the credit unions and the finance companies which have recently entered the mortgage market. Some of these, as we have mentioned, are now making first mortgages up to 80% or more of property values for fairly extended terms. We do not think it necessary to restrict loan values for those companies which raise funds for investment in high-value mortgages (presumably carrying higher risk) through the sale of securities covered by prospectuses. If investors are aware of the companies' investment

[34] We do not wish to suggest that there is a necessary relationship between C.S.B. sales and CMHC direct lending. However, it is interesting to note that from the end of 1956 to the end of 1962 the increases in CMHC's portfolio of insured loans to builders and home-owners of $1.1 billion was equal to roughly half of the increase in outstanding C.S.B.'s.

policies and choose to make this sort of investment, there is no reason to prevent them from doing so. On the other hand, there is a case for restricting the banking institutions and life companies, which accept funds generally from the public, as well as the pension funds which accumulate the savings of members who frequently have no choice about their contributions.

The case for putting some maximum on loan to value ratios does not rest on liquidity grounds. A balanced portfolio of regularly amortizing mortgages—whatever the relationship of individual loans to property values—can be just as liquid as a portfolio of loans or certain types of securities. Rather, it rests on the desirability of offering some guide-lines to institutions dealing with unskilled investors to ensure that those institutions do not make unsound loans and jeopardize the public's savings. We wish to stress that by themselves such ratios cannot guarantee solvency and that a 60% loan on one building may go bad more readily than a 70% loan on another; much depends on the income or integrity of the borrower, the institution's skills in appraising present and prospective property values and the occurrence of unforeseen developments. Similarly, the life of the loan relative to the status of the property is very important; a 20 year mortgage on an old property may prove sounder than a 15 year loan on a somewhat newer residence because of factors such as the condition of the buildings or trends in land values in the two locations concerned. There is no way to determine these factors by formula—it is a matter which requires business skills on the part of the institutions and wisdom on the part of the regulatory authorities.

Nevertheless, such guide-lines have their merits, and we therefore recommend that a maximum loan to value ratio be maintained in the relevant federal and provincial legislation for the life insurance, trust and loan companies and that it also be applied to pension funds and all institutions deemed to be doing a banking function. However, we believe that the experience of the institutions and the development of the mortgage market justify an increase in this ratio to 75%, as suggested by the life companies. An increased limit would not only permit the institutions to finance existing houses on terms closer to those now available under N.H.A., but would help to reduce the borrowers' reliance on high-cost supplementary mortgage financing which—because of the high monthly payments involved—often weakens the position of the first mortgage lender.

This limit would apply as at present to first mortgage loans. Institutions such as the banks which have the power to make unsecured loans without limit can, and quite often do, make what are in effect second mortgage loans without the security of a mortgage. It would be undesirable to prevent them from taking good security on such desirable lending, and the banking institutions should therefore be free to take second mortgages. The 75% limit on first mortgages would thus not prevent them absolutely from advancing a larger amount to a borrower but would forcefully remind them of the need to pay careful attention to all aspects of the borrower's credit standing rather than relying too heavily on the mortgage security itself. Such arrangements will, we hope, inhibit the growth of second-mortgage lenders which make excessive charges while still providing protection for the institutions and their creditors and shareholders against anything but a drastic collapse of property values, from which no reasonable loan to value ratio could protect them.[35]

The residential mortgage market's facilities have greatly improved, especially in recent years, and a number of the remaining shortcomings which we have noted have resulted directly or indirectly from legal or other rigidities which are capable of correction. The relative growth of residential mortgage debt may be slower than it has been during much of the post-war period, and this factor—together with the emergence of new lenders and financing techniques and the increase in competition between established insti-

[35] The various provincial trustee laws contain loan to value ratios which now range from 50% in Manitoba to 75% in Nova Scotia, and the provinces might well want to bring these into line at 75%.

tutions—should lead to further improvements in the services offered borrowers in the future. However, we expect that the mortgage market will continue to be one of the largest users of funds in the economy, and though by its very nature it will never be as sensitive to fractional changes in prices and yields as the securities and foreign exchange markets to which we now turn, it must nevertheless work under arrangements which enable it to respond effectively and quickly to the needs for housing finance. Introducing more flexibility into the N.H.A. rate, bringing new lenders into the market, improving CMHC auction procedures, introducing discount procedures, and increasing permitted loan to value ratios on existing properties should help to achieve this objective and further enhance the usefulness and responsiveness of this market.

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CHAPTER 15

THE FOREIGN EXCHANGE MARKET

The foreign exchange market, in which Canadian dollars and foreign currency claims are traded, is the link between the Canadian financial system and those of other countries. Just as settlement of domestic payments requires an efficient apparatus for transferring money claims from one person to another, so the payments arising out of the flow of international transactions in goods, services and financial claims must be quickly and conveniently settled. This usually involves the purchase of one currency with another in the exchange market. In Canada, the chartered banks are the main financial institutions in this market; at its outer rim are their branches serving the exchange needs of their customers, and at its core is the highly centralized interbank market where the banks meet their own exchange needs in dealings with each other and with the authorities.[1]

THE BANKS' DEALINGS WITH CUSTOMERS

Bank branches are prepared at all times to buy and sell foreign exchange to accommodate the demand and supply pressures which result from their customers' international trade, investment, speculative and other transactions. Some other institutions and companies also provide foreign exchange services for their customers, but all fill their requirements through the banks. The banks, and some other intermediaries, keep a limited supply of U.S. cash and, to a lesser extent, other main foreign currencies and travellers' cheques at their branches to look after demands for foreign cash or its equivalent. However, as in the domestic payments system most transactions, and virtually all large ones, involve transfers of bank balances rather than of notes and coin. Customers needing foreign exchange to make international payments buy claims on balances maintained at the banks' agencies abroad or with their foreign correspondent banks, while those selling exchange obtain Canadian dollars in return for giving their bank title to their claims on foreign banks. Most such transactions are completed by "telegraphic transfers" which are simply instructions to the foreign agent or bank to carry out the appropriate transfers of bank balances, although in some cases customers may wish to buy or sell foreign currency bank drafts. To take a simple example, a Canadian importer will pay his supplier in New Orleans by buying U.S. dollars from his bank branch and asking the branch to instruct its correspondent to credit them to the supplier's own account. If the bank has a New Orleans correspondent it will simply instruct it to make the payment: if not, it will ask its correspondent in, say, New York to transfer funds to the appropriate New Orleans bank. In either case the Canadian bank must carefully manage its correspondent balances to ensure that funds are available to meet its obligation, if necessary by purchasing the required U.S. dollars itself.

[1] We wish to acknowledge our indebtedness to Mr. S. Turk for his paper on *The Foreign Exchange Market in Canada* which contains a fuller description of the market's operations.

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Some large branches have their own foreign currency accounts with correspondent banks in cities where their customers do a substantial amount of business—for instance the main Vancouver branches might well have accounts with Seattle and San Francisco banks—but most branches buy and sell as agents for the head office "foreign exchange" or "trading" departments which hold and manage the main correspondent balances. Since the branches having separate accounts also obtain additional foreign exchange as needed from the trading department and transfer any excess accumulation of foreign funds when their accounts build up, each bank's entire foreign exchange business is funnelled into the head office department. Moreover, all branches buy and sell exchange at prices set by head office: small transactions are completed at buying and selling prices listed in bulletins sent out either daily or as frequently as is justified by changes in exchange rates while larger transactions are settled at current market rates obtained from the department by telephone or telegraph.

In addition to dealing with their customers in foreign exchange for immediate delivery, or "spot" exchange, the banks buy and sell for future delivery in the "forward" market.[2] A bank selling forward exchange to a customer binds itself to deliver the agreed amount at a certain date in the future for a price in Canadian dollars which is fixed at the time of the original contract. No exchange of funds with the customer occurs until the specified date, at which time it will be identical in form to a spot transaction except that the price set initially may well differ from the then current spot exchange rate. Thus an importer who is committed to making a payment in a foreign currency three months hence is able to know the price he will have to pay for his funds when payment is due and an exporter due to be paid in foreign funds can establish the amount of Canadian dollars he will receive. By such "hedging", firms can avoid uncertainty about the rate at which they will buy or sell foreign exchange: moreover, the importer can protect himself against the possibility of having to pay more Canadian currency than that specified in his forward contract, even if our dollar depreciates drastically in the interim, while the exporter is assured of a given return in domestic currency even if the Canadian dollar appreciates. Of course, at the same time, they forego the possibility of an extra profit if the value of the Canadian dollar should move the other way. Some of those having foreign currency receipts or commitments may cover all their expected transactions in the forward market in order to avoid exchange rate risks, while others may never cover forward, preferring to fill their needs in the spot market as and when they arise. A third group may use the forward market at some times and not at others depending on the direction in which they expect exchange rates to move and on the cost of hedging. We have brought together a limited amount of information on the pattern of commercial activity in the spot and forward markets and will review it in the latter part of this chapter.

The forward market is also used in conjunction with international investment transactions. Some of these arise out of commercial receipts and payments, as when an exporter decides to take advantage of attractive interest rates in New York and invest his foreign currency earnings there for, say, 90 days. To avoid the exchange risk on the subsequent conversion of his funds into Canadian dollars, he can buy the latter for delivery in 90 days. If the rate on a 90 day U.S. investment is 4% while the forward Canadian dollar is selling for ¼% below its spot rate, the investment yields a return in Canadian dollars of about 5% per annum.[3] The exporter will be attracted by this "hedged" investment if the overall rate is higher than the yield on a comparable

[2] Spot transactions in the Canadian market are normally completed on the day following their negotiation, but outright transactions for delivery in two or three days are usually done at the spot rate. Commitments further in the future are done at the appropriate forward rate.

[3] It is normal to refer to the forward discount or premium on the foreign currency: in the case cited the foreign currency is said to be at a ¼% premium over its spot rate.

Canadian investment which could be made by selling U.S. dollars at once and investing in the Canadian market for 90 days. The same "covered interest arbitrage" principle applies to short-term international investment transactions having no direct connection with commercial receipts and payments. Those having funds available for short-term investment will transfer them from one market to another by buying the foreign exchange and selling it forward if the covered yield makes such switches attractive. Similarly, short-term borrowers such as sales finance companies will be tempted to obtain funds abroad when the covered interest cost is lower than in Canada. Foreign exchange deals of this sort which involve a simultaneous spot and forward transaction in opposite directions are known as "swaps", to distinguish them from "outright" forward transactions in which no spot exchange is traded. The essence of a swap is that spot and forward exchange are traded at the same time, markets being made in terms of the difference between the two exchange prices. The transactions are completed in the usual way, the spot being delivered promptly and the forward contract maturing on the agreed date.

THE INTERBANK MARKET

In the course of its business with customers, each bank is continually buying and selling spot and forward exchange in outright and swap transactions. Much of this activity is offset within the bank; some branches are buying foreign exchange while others are selling, and it is only the net purchases or sales which affect the position of the bank as a whole. Each trading department tries to avoid the exchange risk inherent in carrying an uncovered position and therefore offsets any fluctuations in its position generated by its branch business as quickly as possible. This is done either in the central foreign exchange market made up of the trading departments of all the Canadian banks and the authorities—the "interbank" market—or by dealing with banks in exchange markets abroad. It is in these markets that exchange rates are determined, both by residual supply and demand flowing in from the banks and by the actions of the authorities—that is the Bank of Canada acting for the Exchange Fund Account, for foreign central banks and international institutions, or on its own account.

Since 1939 the Government has had direct responsibility for foreign exchange policy and the Bank acts as its agent in operating the Exchange Fund Account. This Account is used to influence conditions in the foreign exchange market in ways consistent with government policy. If more foreign exchange is offered than private buyers are willing to take up at existing exchange rates, this excess supply will cause the value of the Canadian dollar to rise unless the Exchange Fund steps in to buy exchange. When the Bank of Canada buys (or sells) for the Exchange Fund in the interbank market, the payment made to (or received from) the chartered bank on the other side of the transaction is debited (or credited) to the federal government's Canadian dollar balances. Thus, while these transactions affect the balance of supply and demand and the level of foreign exchange rates—indeed can be of paramount importance in the market—they do not by themselves affect the aggregate level of chartered bank cash reserves as long as payment is made from or credited to government deposits with the banks. Instead, bank deposits shift among banks and their ownership shifts between the government and others, the effect being analogous to purchases and sales of government securities by the government's domestic securities accounts. Aggregate cash reserves are not changed unless either the Bank of Canada chooses to alter its own foreign currency position or the effect of government financing of the Canadian currency counterpart of Exchange Fund transactions induces the authorities to change the banking system's cash base. It has not been the Bank's normal practice to deal in foreign exchange for its own account with the aim of affecting bank cash, although there is no reason why it, like many other central banks, should not do so if it is found convenient and if it accords with government exchange policy.

Since the adoption of the fixed rate system, the authorities have perforce played a more active role in the market in order to ensure that the rate on the Canadian dollar stayed within 1% of the established parity, currently equivalent to 92.5¢ (U.S.). Put in another way, it requires $1.081 to buy $1 (U.S.) and adherence to the International Monetary Fund agreement specifies that the rate should be maintained between $1.070 and $1.092. The authorities, of course, do not normally wait until our dollar is against these limits before taking action since to do so would be to encourage speculative pressures and reduce their own freedom to manoeuvre. Their more active role in the market contrasts sharply with the position between 1950 and 1960 when, under our floating exchange system, official intervention was normally confined to evening out erratic or excessive short-run movements and was not aimed at establishing or maintaining any particular value for the currency.

Access to the interbank market is restricted in Canada, as in other countries, to the domestic banks and the central bank.[4] The banks never deal directly with each other but buy and sell exchange through brokers in Montreal and Toronto who, since the dismantling of foreign exchange control in 1950, have been salaried employees of the Canadian Bankers' Association. This brokerage system is peculiar to the Canadian market. Prior to World War II, private brokers earned a commission, which was 1/64 of 1% in 1939, on each deal they arranged between banks. They were in business for themselves, but then as now the brokers did not operate for their own account and accepted orders only from Canadian banks. Under the present system, a broker receiving an order from a bank's trading department immediately calls the other banks in sequence, using some discretion based on his knowledge of which bank is likely to be on the other side of the market. If the transaction is for a large amount it may be split among a number of banks. When a deal has been negotiated, all banks—including the Bank of Canada—are notified of the amount, price and settlement date but only the banks involved are told the name of the bank on the other side of the transaction. The market is thus completely impersonal with all banks fully informed of current developments. In this respect it is a more perfect market than the securities market in which trading is less centralized and, even among the large active dealers, knowledge of transactions cannot be as complete. It appears to us that the present arrangements provide an efficient, sensitive interbank market and we see no reason to change them.

[4] The Montreal City and District Savings Bank has access to the market by a special arrangement which recognizes its long connection with the foreign exchange business.

THE STRUCTURE AND GROWTH OF THE MARKET

The U.S. dollar is the most commonly traded foreign currency in the Canadian exchange market, with the pound sterling coming second and other currencies trading in limited amounts. This reflects the close trading and financial connections between Canada and the United States, and, to a lesser degree the United Kingdom, as well as the wide use of the American dollar and sterling for the settlement of international debts. The chartered banks thus carry their main correspondent balances in U.S. dollars and sterling, maintaining small working balances in other currencies and obtaining any sizable amounts for customers by purchasing the required funds with one of the major currencies or by crediting the Canadian dollar account of the correspondent bank concerned. The spreads between the rates at which branches buy and sell U.S. dollars in amounts up to the branch limit—normally $10,000—are in most cases ¼% for transfers and 1% for notes and coin. These spreads are maintained to cover costs, to provide some protection against very recent rate changes of which all branches will not have been informed and to provide a margin of profit. Spreads are narrower on large transactions on which current rates are obtained from head office. Less active currencies trade at wider spreads, although large sterling transactions are done at spreads close to those for U.S. dollars.

Swaps and outright forward transactions, on which narrow spreads are maintained, can now be negotiated readily with banks for periods up to six months, with most being for three months or less. Arrangements can be made for periods over six months but they are comparatively rare. Most forward contracts mature on a particular day, but some allow for completion within a specified period at the option of a customer if he is not certain of the exact date of delivery: the banks charge slightly more for such optional contracts in order to cover the additional risk and inconvenience. In all of a bank's forward dealings with customers there is a possibility that the customer will be unable to complete transactions when they fall due. Since the bank will normally have committed itself to offsetting forward transactions in the course of managing its foreign exchange position, it may incur a loss in such circumstances because of having, for example, committed itself to pay more than the current spot rate for funds in order to meet the needs of a customer who subsequently defaulted on his forward contract. For this reason, banks normally enter into forward contracts only with customers having established lines of credit (indeed a limit on their forward contracts is often a part of the line of credit arrangements) or require that a customer put up some cash at the time the contract is entered into.

Just as currencies other than the U.S. dollar and sterling do not trade at all actively in the Canadian exchange market, so the market in Canadian dollars is much more active in Canada than elsewhere. Most of our external trade is invoiced in U.S. dollars or sterling and not in Canadian dollars, with the result that the exchange conversion problem is usually left to the Canadian firm rather than its foreign customer or supplier. Canadians having business abroad must usually deal in foreign exchange whereas residents of other countries may carry on their business with Canadians without dealing in Canadian dollars. Thus the principal market is in Canada where the Canadian firms doing an international business have their main banking connections. Similarly, the principal market to which the chartered banks turn in order to manage their own trading and investment positions is the Canadian interbank market.

These markets are, however, fully integrated with those in other countries. In addition to checking the prices quoted by one or more Canadian banks, a firm having exchange business may well contact banks abroad, particularly in New York, Detroit and other American cities where banks make markets in Canadian dollars, but also in London. Because of the activity of subsidiaries whose parent companies have their main banking connections in their own country, particularly the United States, and because some foreign banks devote considerable attention to Canadian exchange business, direct dealings between Canadian firms and foreign banks have increased in importance in recent years. Whereas Canadian banks quote Canadian exchange to the nearest 1/32nd, New York banks have commonly quoted in 1/64ths and some of them, as well as banks in active centres such as Detroit, quote to the nearest 1/100th, or even 1/1000th, of a cent.

Similarly, the Canadian banks deal with banks abroad as well as in the domestic interbank market, buying and selling exchange wherever they can obtain the best price. In earlier years, when the domestic market in short-term investments had not been developed, it was customary for Canadian banks to carry out most of their exchange transactions in New York since it was the main market in which the banks bought and sold the short-term claims used to adjust their cash and liquid positions. The growth of the domestic market in liquid assets, the increased role of the authorities and the effect of exchange control, which broke established links with New York, have contributed to the replacement of New York by the domestic interbank market as the main centre for the banks' exchange transactions. Indeed, New York banks now bring much of their Canadian exchange business to our interbank market. In 1961 $1.8 billion of outright transactions went through the interbank market, compared to $1.2 billion in 1953, while

a much larger volume was done with customers but netted out within individual banks. The market in swaps between banks has expanded much more rapidly, from a volume of $.3 billion in 1953 to $1.7 billion in 1961. The salaried broker system adopted in 1950 has also been an undoubted factor in the growth of an active domestic interbank market, for the banks no longer need pay brokers' commissions in Canada as they do in other markets. Moreover, it has led them to deal in the market more frequently than they used to since there is no extra cost in turning to the market to cover spot and forward positions as they occur; formerly, they would tend to carry a position longer in the hope that further trade with customers would provide the necessary offset and save the cost of commissions.

The growth of the Canadian exchange market in the post-war period also reflects the expanding volume of Canada's international financial transactions. However, balance of payments statistics cannot be related directly to activity in the foreign exchange market, partly because of the difficulty of tracing and recording complex international transactions included as a residual item with short-term capital flows in order to balance the accounts. But quite apart from this difficulty, which is common to all countries, balance of payments statistics are intended to record changes in the balance of claims between Canadian residents and foreigners rather than gross transactions in the exchange market. For instance, a province selling a bond issue in New York might temporarily hold the proceeds in a bank account or in some other U.S. dollar short-term asset which would be reflected in the balance of payments statistics as a long-term capital inflow matched by a short-term outflow even though no transactions have gone through the exchange market. In other cases the borrower will use the proceeds of foreign issues to purchase foreign goods or an exporter will use his own foreign currency earnings to pay for imports. In both cases there will be entries in our international accounts,[5] but neither involves conversion of exchange. Finally, there is very limited information available in the balance of payments statistics and elsewhere about activity in the forward market, which plays a crucial role in the exchange market's overall volume. Nevertheless, there has been a broad tendency for market activity to reflect the growth of Canada's foreign financial dealings as well as the improvement in its own facilities.

[5] The first will be reflected in a capital inflow with matching imports, the second in matching exports and imports.

SPECIALIZED TRANSACTIONS IN THE MARKET

The foreign exchange market is a sophisticated one in which an increasing number of participants are keenly aware of the opportunities for profit and the danger of losses from changes in exchange rates. Moreover, there is a growing sensitivity to the possibilities of moving funds from one country to another in response to interest rate differences. We have already discussed briefly in Chapter 5 the ways in which these considerations, in conjunction with many others, bear on Canada's international financial position. To round out the present discussion of the exchange market, we will comment on the principal market transactions through which the effects of speculative pressures and interest rate differentials work themselves out, leaving for Chapter 23 an assessment of their implications for financial policy.

(i) *The Banks*

The policies and practices of the chartered banks are of course of great importance to the working of the market. The banks as a matter of policy do not speculate on the exchange rate in the majority of their dealings, preferring to forego the potential profits of successful speculation in order to avoid the possibility of equally large losses on uncovered foreign exchange positions. Each trading department's first concern, apart from the mechanics of seeing that transactions are duly completed for its customers, is therefore to ensure that commitments to customers are covered against the risk of losses from adverse changes in the level of rates, or in the case of forward commitments, in the spread between spot

and forward rates. Changes in their spot obligations to customers are normally offset by immediate offsetting purchases or sales of spot exchange in the interbank market. The major risks associated with changes in a bank's forward position can also be much reduced by offsetting transactions in the spot market[6] since parallel movements of spot and forward rates are in practice larger and more frequent than changes in the forward differential. A further reason for using the spot market to match forward as well as spot commitments is that it is often difficult and time-consuming to find another bank wishing to do a corresponding outright forward transaction, and delay brings serious risk of loss. Having covered the most serious risk in the spot market and preserved a balanced "overall" position, a bank may find itself with a short forward position (i.e. it is committed under forward contracts to sell more foreign exchange than it has undertaken to buy) matched by a long spot position, or vice versa. It will then bring the two into line as soon as possible by entering into swaps with its own customers or other banks to cover the secondary risk that the forward differential will alter. Subsequent swaps may be necessary to cover the time differences between the maturities of different forward contracts. In this manner each bank is continually taking on its customers' exchange business and then sorting out its own trading position in the interbank market with a series of spot and swap transactions. Since the banks usually attempt to offset changes in their own positions arising from customer transactions, their trading behaviour merely reflects underlying supply and demand from those customers and does not have an independent effect on market behaviour except over the very short periods when they are balancing their spot and forward commitments.

[6] Thus a bank commitment to sell a customer U.S. dollars in 30 days will normally be accompanied by an immediate purchase of U.S. currency in the interbank market. This assumes, of course, that the bank was in a balanced position prior to the forward sale and that other transactions for customers do not immediately provide the necessary offset. It also assumes that the bank's policy about covering its trading position does not alter.

In addition to handling customers' business, the international departments also co-ordinate the banks' own foreign currency business, and operate in the market for the banks' own accounts. It was noted in Chapter 7 that the net foreign currency position of a bank—as distinct from the operating position of its trading department —may fluctuate considerably from time to time in line with the bank's investment policy. A bank which draws on its foreign position as part of the liquid asset adjustment to domestic monetary pressure sells foreign assets, obtaining Canadian dollars. (If the exchange is sold to another Canadian bank or to one of its customers, resident or non-resident, the selling bank receives a claim on another bank which when cleared and settled will increase its cash reserves at the Bank of Canada at the expense of that bank. The process is exactly the same as if the bank had obtained cash by realizing on its domestic liquid assets. In either case, banks can draw cash from each other —and if sales are made to bank customers can reduce Canadian dollar deposits—but their transactions do not increase aggregate cash reserves unless the Bank of Canada acts on its own account.) When the banks vary their net foreign asset positions in this way, they normally do so as a temporary expedient and cover the spot sales of foreign exchange with forward purchases, hedging these fluctuations just as they cover swings in their trading positions. When the domestic monetary situation eases they tend to rebuild their net foreign positions by completing the forward purchases. However, the banks may on occasion take a view of the future course of exchange rates by altering their uncovered foreign position, although such actions are not usual and do not involve large amounts in relation to the volume of business done.

(ii) *Speculative Transactions*

Many other participants in the market are more willing to take speculative positions. Those who expect the Canadian dollar to depreciate can and do speculate in the spot market by buying foreign exchange in the hope of reselling it at a profit if their judgment proves correct. Such

speculation brings pressure to bear directly on the spot rate or exchange reserves, or both. They may also speculate by buying foreign exchange forward in anticipation of a profitable sale if the expected movement occurs by the time the contract matures. Forward speculation is less costly than spot purchases in that funds do not have to be committed as they do when the speculator buys spot exchange and holds it—perhaps invested in highly liquid form in foreign markets—for later sale. The effects of forward speculation will be felt in the spot market as well since it will tend to induce capital flows which will bring immediate pressure on the dollar. By initially depressing the Canadian dollar in the forward market, they make it more profitable than formerly to buy foreign exchange spot and sell it forward in order to make short-term investments abroad.[7] In practice the manner in which the chartered banks manage their foreign positions tends to transfer pressure immediately to the spot market because they cover their forward sales of exchange by buying spot exchange at once. As they subsequently balance out the resulting short forward and long spot positions they will sell the spot exchange to others. The result is that someone outside the banks will have been induced by the increase in the covered interest return available on foreign investments to sell Canadian dollars spot. Speculative pressure in the forward market, unless it induces counterspeculation or new commercial offerings of forward exchange,[8] is thus transferred to the spot market through short-term capital outflows which tend to lower the value of the Canadian dollar or drain official foreign currency reserves.

The transactions discussed so far are "pure" speculation in the sense that they are not related to the normal flow of international trade and investment. Our enquiries suggest that such speculation is much less important than that carried on by firms and individuals whose regular business brings them into the exchange market. Commercial firms expecting the Canadian dollar to depreciate may speculate in the spot market by delaying conversion of their foreign currency receipts and hastening the payment of foreign currency indebtedness. This "leads and lags" process can bring immediate pressure to bear on exchange rates and official reserves, with much of it taking the form of changes in the indebtedness between Canadian subsidiaries and their foreign parent companies. Research carried out for us, however, indicates that a high proportion of speculation in the market is done through forward contracts, with business and other users of foreign exchange altering their policy of covering future requirements as they change their view of the exchange rate.

Many commercial firms have a set policy of using only the spot market and never cover forward receipts and payments. In this connection, the Canadian Manufacturers' Association asked its members dealing in the exchange market what their policy was, and 77% indicated that they never used the forward market, or did so only infrequently, only 11% replied that they usually hedged their transactions in the forward market and the remaining 12% reported that they frequently used the forward market, particularly when it appeared advantageous in view of their expectations about exchange rates.[9] While our own survey of corporate financial policies did not enquire closely into exchange practices, the information we did obtain—which is summarized in the following table—indicated that rather fewer of the firms in our sample invariably dealt in the spot market and somewhat more always cover their commitments forward.

Differences in the replies to these two surveys probably result in large part from the fact that our survey covered substantially more large firms. It will be noted that the distribution of replies from firms with assets of less than $10 million is quite similar to that reported by the C.M.A. These smaller firms probably make relatively little use of the forward market because they are not familiar with it and because their transactions

[7] The effects are, of course, reversed if the speculator is looking for an appreciation of the Canadian dollar and sells forward exchange.

[8] Or induces the authorities to offer forward exchange—see Chapter 23.

[9] See Table 8 of the Submission of the C.M.A.

FOREIGN EXCHANGE PRACTICES
PERCENTAGE DISTRIBUTION OF REPLIES

Assets of Firm	Always use the Spot Market	Occasional or Frequent Forward Transactions	Always use the Forward Market	Total
Under $10 million	76%	6%	18%	100%
$10 million and over	51%	10%	39%	100%

are not large or regular enough to justify the costs of devoting time and resources to decisions about their exchange business. Considerably fewer large firms invariably meet their needs as required in the spot market and more of them cover all anticipated purchases and sales of foreign exchange in the forward market as soon as trade or other commitments are entered into. Relatively small proportions of small and large companies, but more of the latter, make selective use of the forward market. This group includes firms which tend to obtain forward cover for unusually large transactions and those which speculate by covering when they expect the exchange rate to move against them, and not doing so when they expect a favourable change in the rate. We found evidence of large purchases of forward U.S. dollars by such companies in the spring of 1962 and their activities appear to be a major element in exchange speculation at all times. In addition, our survey shows that some firms speculate by altering the timing of their spot transactions or by taking forward or spot exchange positions unconnected with their ordinary business. In total some 8% of firms speculate in one way or another.[10]

These remarks on exchange speculation are based largely, although by no means entirely, on experience under the floating exchange rate system. There has been foreign exchange speculation in Canada since the fixed rate was established just as there is in other currencies under fixed rate conditions. Indeed some respondents to the survey indicated that their policies about the use of the forward market have not altered. However, early indications are that participation in the forward market generally will be reduced for commercial transactions in ordinary circumstances, although short-term investment flows will continue to be hedged. Speculation in all forms may, of course, become extremely heavy if doubts develop about the maintenance of the existing rate.

(iii) *Short-term Capital Flows*

While speculative forces can give rise to large short-term capital flows which at times dominate the behaviour of the foreign exchange market, such flows also result from changes in the cost and availability of funds in Canada relative to other countries, particularly the United States. We have already indicated in Chapter 5 how changing interest costs between the two countries influence long-term capital flows. Some types of short capital movement also respond to such changes, particularly when availability as well as cost is involved, the most important of these being international trade credit. This particular type of short capital flow cannot be analysed very rigorously because it is not shown separately in the balance of payments statistics and because —as already indicated—it also responds to speculative forces. However, the heavy inflow of funds in periods of credit restraint such as 1956-57 and 1959, and the much reduced inflow in years of domestic monetary ease like 1958 suggest strongly that Canadian firms do draw on foreign funds in this way when credit is relatively costly and difficult to obtain in Canada. This is particularly true of Canadian subsidiaries of foreign companies which naturally look to their parent firms for a substantial part of any marginal financing requirements.

While absolute interest rate differentials do set off short as well as long-term capital flows, there is always the possibility that even a small adverse movement in the exchange rate may wipe out the profit obtained by moving short-term funds to take advantage of higher interest rates. Thus,

[10] Further discussion of practices in the foreign exchange market will be found in the appendix volume.

if the U.S. yield on three month treasury bills is 4% compared to a 5% yield in Canada, the advantage of moving funds into Canada would be eliminated if the U.S. dollar appreciates by about ¼ of 1% in Canadian funds over the three month period. In contrast, it would take an appreciation over the entire life of the borrowing of over 14% to offset a 1% yield advantage on a 20-year foreign currency bond issue.[11]

In order to obtain protection against the risks involved, many short-term international investment and borrowing transactions are hedged in the forward market and respond, therefore, not to absolute interest rate differentials but to the differential as adjusted for the cost or profit of forward cover. Unlike long-term flows and the uncovered short-term movements mentioned above, these covered flows thus tend to produce rather small net flows of funds. For example, if Canadian short-term interest rates rise relative to those in New York, foreign investors will be tempted to move funds to Canada and Canadian borrowers will seek short-term funds in New York. Both will wish to cover their future exchange requirements since the lender will be anxious not to earn a lower return than he could obtain by investing in his own currency and the borrower will not wish to incur higher costs than he would pay in the Canadian market. The forward U.S. dollar will thus appreciate very quickly and check the outward flow by reducing the lender's return and raising the borrower's costs. Large amounts can and do move in both directions in such circumstances but the net flows will be smaller than in the case of uncovered movements which will only be checked, other things being equal, when they have led to a restoration of the original interest rate differential. When transactions are covered, and there is no offsetting speculation or commercial buying of forward exchange, the forward rate will adjust rapidly to changes in the interest rate differential so that no advantage in moving funds on a covered basis remains.

In recent years there has been a rapid development of the instruments and techniques of interest arbitrage—indeed, this is perhaps the most notable development in the structure of the exchange market. Corporate treasurers have become increasingly sensitive to the returns available on short-term investments while banks and investment dealers in Canada and abroad have evolved a variety of channels for facilitating arbitrage transactions and have induced investors and borrowers to make use of them to tap the international capital market. The main types of transaction involved are covered investments in commercial and finance company paper, and to a lesser extent in treasury bills, and the "swap deposits" offered by chartered banks which were described in Chapter 7. The implications of these developments for policy will be discussed more fully in Chapter 23. Our present purpose has simply been to draw attention to the increasingly close links which the development of the Canadian foreign exchange market has forged between the capital markets of the world and the Canadian money and financial markets.

[11] See Chapter 4.

CHAPTER 16

INVESTMENT DEALERS AND THE BOND AND MONEY MARKETS

The function of the bond and money markets is to facilitate the issue of new securities by those with borrowing needs and to encourage the holding of debt obligations by those with available funds. Serving the financial institutions as well as the general public, these markets act as a convenient and readily accessible guide to the values of debt instruments and as a central meeting place where the orders of buyers and sellers can be quickly and efficiently brought together. They thus add to the ease with which obligations can be bought or sold if the need arises and make lenders and borrowers more aware of the terms on which business may be done between them. The investment dealers play an important part in this process by bringing buyers and sellers into the market, by matching and executing their orders, and by providing related financial services and advice. The dealers also contribute significantly to the working of the markets by participating in trading for their own account and by adjusting the level of their holdings to meet the needs of their customers.

If these markets are functioning well, borrowers and lenders will be brought together at minimum cost and changing investor preferences and shifts in the demand for funds will be quickly and accurately reflected in prices and yields. Broad, deep, sensitive and adaptable markets thus play an important role in allocating the nation's real resources and in determining the efficiency with which they are used, both by reducing the cost and increasing the availability of funds in general and by channeling funds to developing industries. As indicated earlier, these markets are also the primary vehicles through which the authorities influence credit conditions and through which much of their impact is transmitted to the rest of the economy.

The bond and money markets have broadened and grown significantly in recent years and, although still suffering from imperfections, have shown themselves remarkably adaptable to changing conditions. The dealers have been at the heart of this process and it is not surprising that a feeling of importance, a lively sense of innovation, and an atmosphere of brisk activity are to be found in the industry. Yet the industry is also a study in contrasts: pioneering in some areas is accompanied by traditionalism and caution in others; an attitude of constructive enterprise designed to serve the real needs of the economy exists side by side with excessive anxiety to avoid risks and—at the fringes—with an exclusive preoccupation on making a quick profit from transactions of a more dubious value; finally, the hard work and dynamic spirit of most individuals in the industry may be set against the comfortable willingness of some of its participants to rest on the fruits of past luck or resourcefulness.

Basic forces are, however, exerting an inexorable impact on the industry and forcing it to become more professional and competitive. The increasing institutionalization of savings has put enormous amounts of investment funds in the hands of skilled professionals who expect com-

petent and experienced service and who set high standards in the purchase of securities, particularly new issues. The growing importance of these customers and the spectacular development of the money market—whose participants are mainly corporate treasurers and others skilled in the financial business—have forced the industry to recruit and train more professional personnel and to break with its traditional belief that university education was less appropriate than routine on-the-job training. Moreover, the growing size of the markets has made them more impersonal, and this has also contributed to the fact that clients of all kinds have become less satisfied with the cheerful order-taker who can provide price quotations and uninformed gossip but who knows nothing about the underlying economic and business developments which ultimately influence market behaviour.

The growing professionalism of its clients has also forced the industry to adopt more competitive attitudes and led to a paring of its trading margins on both new issues and outstanding securities. Nowhere is this more true than in the money market which, because of its recent development and skilled and impersonal nature, has been largely free of traditional ties and relationships and has thus been open to vigorous innovation and price-cutting. Nevertheless, the same trend is noticeable in the bond markets, particularly for larger sales, and in underwriting, where new issues are increasingly being placed with large buyers at a much reduced fee. In addition, abnormally high demands for capital from corporations have receded, and such clients are no longer willing to pay the same substantial underwriting commissions. Government issues have been large, but margins on these are smaller so that competition for corporate business has become more intense. We would not want to exaggerate the importance of these developments or to suggest that the character of the industry will be altered over-night, but the main trends are clearly visible and are reflected in industry mergers and pressures to attain a new level of efficiency and skills.

Although there are some 400 securities firms in Canada, those which do an investment dealer business number slightly more than 200, almost 190 of which are members of the Investment Dealers' Association of Canada (the I.D.A.). More than 60% of the latter are also members of a recognized stock exchange in Canada or have stock exchange affiliates, usually operating from the same premises and having much the same management and officers. These activities and those of broker-dealers, which account for the balance of the securities industry, will be discussed in the next chapter. The number of firms in the investment dealer industry has declined by about 10% over the past decade, although the number of branches has continued to expand, reflecting the pressures referred to earlier as well as the attempt of some firms to spread their costs and make full use of skilled head office departments by providing a national service. About two-thirds of the 340 branch offices of I.D.A. members are located in the provinces of Ontario and Quebec, mainly in Toronto and Montreal where much of the country's financial activity is centred. There is also a tendency to serve smaller communities through agents or salesmen rather than branch offices. The industry, which is predominantly Canadian-owned, also has almost 40 branch offices or affiliated companies operating outside Canada, mainly in the United States and the United Kingdom.

One of the distinguishing features of the Canadian industry is its relative lack of specialization. The largest and most profitable firms are fully integrated; they underwrite and distribute new issues, position and trade debt and other securities, sell wholesale and retail, operate in the money market, have memberships in one or more stock exchanges, manage portfolios, and in general perform the whole range of functions common to the industry. The growing houses gradually take on these functions and offer a more complete service to their clients while the many firms that remain small and local also tend to be very general and unspecialized. Only a few firms have concentrated their efforts on the

wholesale or institutional market or on municipal and local issues. This contrasts sharply with the United States industry in which firms have specialized in a wide variety of ways, a development which may occur here as well when Canadian markets have grown further. A typical Canadian firm now has about one-quarter of its personnel engaged in sales, a further 10–12% in trading, up to 5% in underwriting and security analysis, 10% in senior administration, and the balance in routine accounting, delivery and clerical functions.

Another striking characteristic of the investment dealer industry is the dominant position of a few houses. Eight of the 124 firms reporting to a 1961 I.D.A. financial survey undertaken for us (the others reported through similar stock exchange surveys) had no less than 46% of the total capital and earned 51% of the net income; in 1962 the figures were 47% and 45% respectively. These firms are all national in scope, two of them operating in all but Newfoundland and the remainder in at least six provinces. In the earlier year, six of these firms, acting alone or as syndicate managers, underwrote approximately 90% of the dollar amount of all public utility issues, 60% by value of industrial bond issues, 65% of the sums raised through stock issues and also dominated the provincial and large municipal underwritings. Although these firms have attained their position because of their placing power and experience, their dominant influence in underwriting contributes to the existence of some of the rigidities and imperfections we will be discussing later. A further 24 houses that carried security inventories in excess of $1 million accounted for an additional 30% of the industry's capital and 28% of its profits in 1961 (29% and 30% in 1962) and have tended to improve their share of earnings at the expense of the largest firms.

Trading and underwriting have accounted for between 81% and 85% of investment dealers' earnings in recent years, with underwritings alone accounting for between 50% and 60% of income. Stock market commissions account for most of the remaining income and tend to fluctuate in significance directly with the behaviour of stock market prices. In the six years reported in the I.D.A. survey, the aggregate net income as a proportion of capital and surplus of its members fluctuated between a low of just over 9% and a high of 17% as is shown in the following table:

NET INCOME AS A PERCENTAGE OF TOTAL CAPITAL
(Excluding Loans)

—	1951	1956	1959	1960	1961	1962
Reporting Members I.D.A.	14.5	17.0	10.7	10.2	11.4	9.2
Eight National Houses	17.1	18.5	10.7	12.0	12.7	8.6

SOURCE: Submission of Investment Dealers' Association of Canada.

The profit experience of the industry has been healthy, comparing favourably with most other industries and with the returns or other financial businesses already described. Moreover, the true level and trend of earnings may be more favourable than indicated above since an increasing proportion of revenue after all expenses but taxes and remuneration to partners and shareholders has been paid to the owners in the form of salaries and bonuses. The increase in this ratio may reflect nothing other than the need to pay more competitive salaries and the increasing tendency to offer shares in the firm to a greater proportion of employees (about 20% of all employees are now shareholders), but the fact remains that salaries and bonuses had risen by 1962 to more than three times their 1951 level. As the owners and managers of the businesses are the same group, it is a matter of convenience whether the returns from the operation are distributed in the form of salaries or dividends, and it is not known to what extent, if any, such payments are out of line with comparable salaries elsewhere for personnel with similar skills. If anything, they may slightly depress reported profits for the industry as a whole, although there is great variation between individual firms. Net

profits as reported, and averaged for the years shown in the table above, are just slightly below those for American federal government securities dealers in the period 1948-58 but are well above the average pre-tax return of only 6.4% earned by all incorporated U.S. security dealers, including stock brokers, in the same period.

The following table gives an analysis of the allocation of revenues in the industry in the years 1951 and 1962:

TABLE 16–1

DISTRIBUTION OF INVESTMENT DEALER REVENUE

	1951			1962		
	Categories			Categories		
	A	B	C	A	B	C
Revenues ($ millions)	13,895	4,160	6,934	29,879	17,150	13,995
Expenses:						
Employee compensation	30.3%	36.3%	39.1%	37.9%	35.6%	39.8%
Communications	9.1	10.0	8.8	10.5	10.1	8.1
Occupancy and equipment	4.7	5.5	5.3	6.5	6.0	6.3
Promotional	3.8	2.9	4.7	4.7	3.9	3.9
Other	6.1	6.5	8.3	6.3	7.1	7.8
Income before remuneration to shareholders or partners and income taxes	46.1	38.8	33.7	34.1	37.3	34.1
Deduct:						
Shareholder salaries, bonuses, and other compensation	13.1	13.8	16.3	19.2	20.6	20.3
Income taxes	15.9	11.9	5.5	6.7	7.2	4.5
Net Income	17.1	13.2	12.0	8.1	9.4	9.4

NOTE: Category A = 8 national houses; Category B = 24 major positioning houses; Category C = all other reporting members.

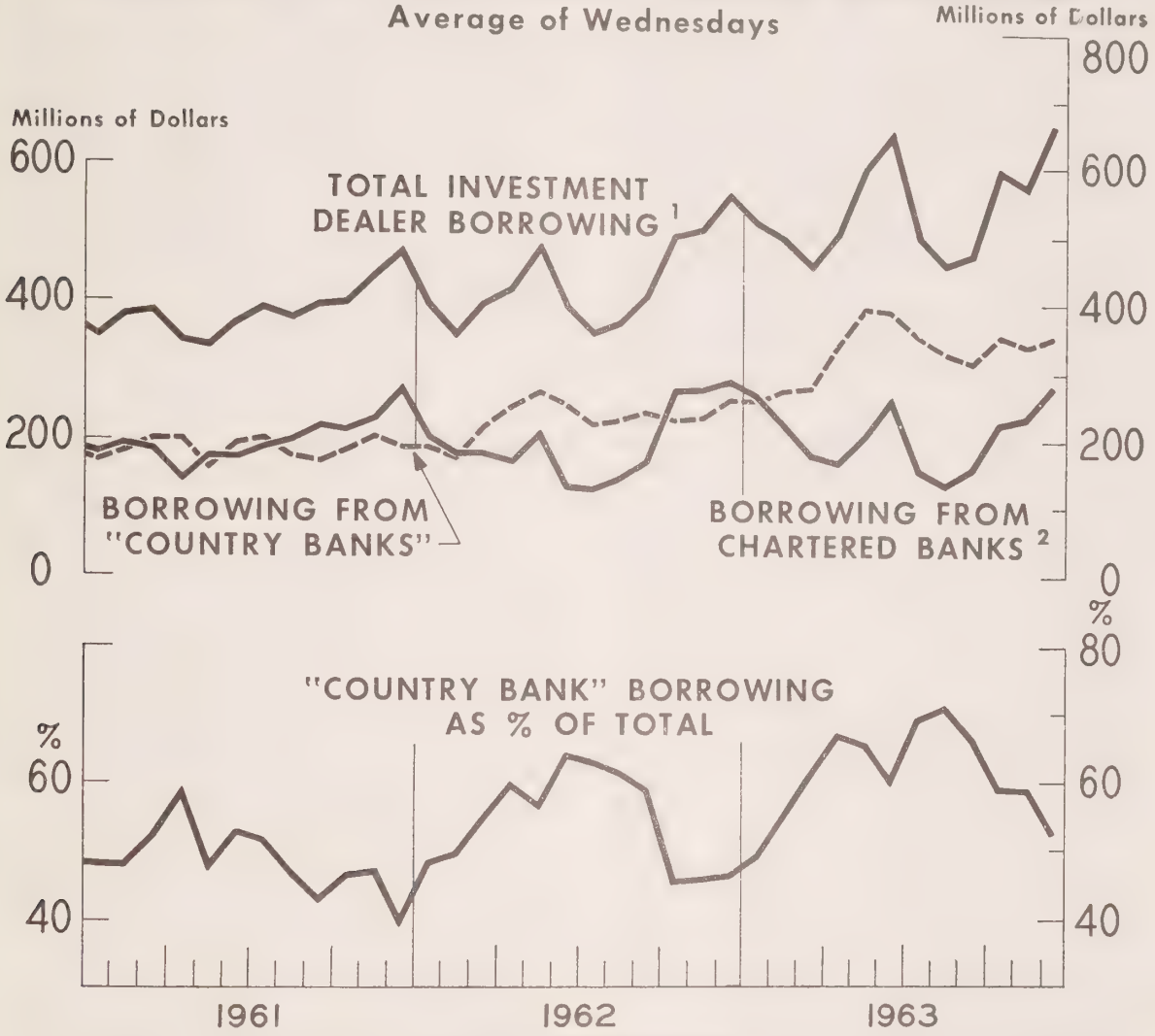
As a service industry, the proportion of revenues allocated to wages and salaries is necessarily high. Yet the dealers also require substantial amounts of equity capital and borrowed funds to carry inventory, to cover underwriting liabilities, to service margin accounts and to cover short-term liabilities in connection with current transactions. The foundation of their enterprises is the amount of capital and undivided profits in the business, the minimum amounts of which are regulated by the Association under a formula which relates them to the volume of liabilities. In 1961 the capital of the I.D.A. members reporting in the survey was $61 million (almost $66 million if subordinated loans from shareholders and borrowings from affiliated companies are included). This sum, which represents an investment of about $12,000 for each of the industry's 5,400 employees and which compares with $26 million a decade earlier, supported total borrowings of over $447 million, a ratio of 6.8 to 1. Bank and non-bank borrowing by the dealers is shown in Chart 16-1 and reveals the growing share of the latter, particularly in tight money periods.[1] Such "country bank" borrowing first became significant in response to the monetary tightness of late 1958 and 1959 and grew in importance when bank call loan rates remained high and out of touch with the market in 1960. In the restraint associated with the 1962 exchange crisis in May and June, country banks were supplying up to 70% of the funds borrowed by

[1] Figures for non-bank, or country bank, borrowing are not available prior to November 30, 1960.

Chart 16-1

FINANCING OF INVESTMENT DEALER INVENTORIES

Average of Wednesdays



1. Includes purchase and resale agreements with the Bank of Canada as well as chartered and "country" bank borrowing.
2. Day-to-day loans plus call loans to investment dealers.

dealers and the absolute amount had grown to almost $300 million (it has since exceeded $400 million on occasion).

The industry's capital appears to be adequate to permit it to perform efficiently its role in the economy. Its willingness to hold inventories of money market securities has increased substantially as market experience has been gained and we have found no evidence that shortages of capital have been a limiting factor to this expansion. Total inventories have grown from $46 million in 1951 and $212 million in 1956 to $485

million in 1962, a factor which has contributed no little to broadening the market even though the industry may be still somewhat conservative in some aspects of its inventory policy. A comparison of the ratio of inventory holdings to net worth of the eight Canadian national houses with that of the United States government securities dealers shows that the Canadian firms operate with relatively more capital. While their inventories in relation to capital increased steadily from 1951 to 1961, the ratio on a gross basis was only 9 to 1 in the latter year, compared to an average ratio for the United States firms in the period 1948-58 of 15 to 1. Within the periods studied there were of course substantial fluctuations, the lowest ratio for Canadian and American firms being 2.4/1 and 9.1/1 respectively and the highs being 9/1 and 26/1. Some allowance must be made for the differences in the Canadian and United States dealers' portfolios, but these figures do not support the contention that our industry is relatively under-capitalized. The U.S. dealers, with federal government securities making up about 90% of their portfolios, had only about 10% more of their holdings in these relatively riskless issues than the Canadian dealers, who had a correspondingly higher proportion of other government and corporate bonds (as well as a small amount of stocks) which required higher margins.

Nor can we ascribe such weaknesses as exist in the underwriting field, including the at times almost unseemly haste with which new issues are sold, to a shortage of industry capital. We could find no evidence that firms refused underwritings because of inadequacies of their own capital, and indeed received complaints that there was not sufficient new issue business in relation to the industry's capacity. Any firm that does find its capital strained can bring additional firms, and banks, into its underwriting syndicate to share the liability. Alternatively, it may have access to subordinated loans or other funds from shareholders or associated companies.

This is not to argue that more capital in the industry would not be desirable or helpful, but simply to state that we find no persuasive evidence that shortages of such equity limited the effectiveness of the dealers as a whole. Moreover, we found the industry's capital adequate on the whole to protect the public from any default due to unfavourable market or other developments. The I.D.A. standards seem reasonable in this connection, although we suggest that the minimum requirement of $25,000 should be raised again. Capital requirements are enforced by annual and sample interim audits, close checks on new members, and a willingness to take quick disciplinary action. However, only the Ontario and Pacific districts require a regular filing of financial information from all members in addition to the annual audit. This does not seem to provide an adequate check on members and the I.D.A. might well adopt a system of employing outside examiners. The provincial securities administrations have responsibilities in connection with the adequacy of capital and can make periodic checks although for the most part they are satisfied to leave the task to the self-regulatory associations. In our view, the authorities ought to take a more active interest to ensure that the associations continue to perform their functions well. Moreover, the industry ought to improve the protection of the public from the risk of such losses as fire, theft, forgery and unexplained disappearance. The I.D.A. has recently raised the required minimum insurance coverage for such risks to $100,000 from $30,000, but the minimum requirements would be more appropriately related to the size of business transacted—a practice followed by many members in any event.

These safeguards for the clients of the industry are the more essential because of the lack of information about the industry. All the Canadian firms are partnerships or private corporations and consequently not required to disclose information about themselves. Persons doing business with them must, therefore, rely upon the firm's reputation and the regulation and supervision of the authorities and the industry itself. In our view, steps should be taken to remedy this lack of information, particularly since some dealers are financial intermediaries in the sense that they

accept short-term deposits from corporations, and solicit funds from others, and since all dealers are similar to the institutions in having on hand substantial customer credit balances. The protection of the public is also involved because the dealers hold clients' instruments in safe-keeping, sometimes in unregistered form or registered in the dealer's own name,[2] and undertake large underwriting liabilities. Finally, the dealer's own inventory activities, another intermediary function, can have important effects on the money and bond markets, and more should be known about these activities.

Information is now available at least quarterly on the major assets and liabilities of the most important financial intermediaries and we consider it desirable that similar aggregate data,[3] including a combined annual earnings statement, be published regularly for the investment industry. A first partial step in this direction would be for the I.D.A. to release publicly its country bank borrowing statistics now collected weekly for the use of the industry.[4] Moreover, firms issuing promissory notes or accepting deposits in other forms, including credit balances of clients, should also be required to make individual financial statements available on request —as some now do—to the owners of these liabilities. The authorities, borrowing and investing public and, perhaps most of all, the securities industry itself would benefit from the results of this fuller disclosure. Indeed, many investment firms in the United States, including affiliates of Canadian firms, now publish at least their individual net worth figures and we hope the Canadian industry might find it a useful practice to do the same. The I.D.A. and the stock exchanges were most co-operative in collecting and collating data for us on their sections of the industry and are now in a good position to continue such collections on a regular basis.

[2] These must, however, be segregated in their accounts and held separately.

[3] D.B.S. is now collecting quarterly balance sheet information.

[4] These should be improved by the inclusion of short positions.

In making these recommendations, we do not wish to under emphasize the substantial role played by the I.D.A. in protecting the public and improving industry standards. Founded in 1916, representing dealers across Canada and divided into six administrative districts, its principal function is to encourage sound financial practice and high ethical standards. In these activities the understaffed securities administrations have given it substantial scope and responsibility and only the occasional prodding. Despite the inherent difficulties of self-regulation and the particular problems entailed by the concentration of power in the industry, the Association has made a valuable contribution in this field and is seeking to raise standards still further. The I.D.A. has also undertaken an active educational program for its members' employees and for the investing public and has recently imposed minimum qualifications on sales staff. In addition, the Association represents the dealers in discussions with public and other bodies, prepares and distributes a variety of publications, and provides a limited although increasing amount of statistical data. The basic ground rules for trading and for carrying out securities transactions generally, except for stock exchange transactions, are also set by the Association.

UNDERWRITING

In no activity do the dealers influence the allocation of real resources and the level of economic activity more than through the underwriting and distributing of new issues. Substantial amounts of funds are raised each year by the investment community, which in 1962 underwrote or helped to place most of the $2.7 billion of gross new provincial, municipal and corporate issues shown in the following table; in addition it helped to distribute the $3.4 billion of Government of Canada direct and guaranteed securities issued in that year.

The table shows the growth in the amount of security issues in the post-war period, the shift away from corporate issues in recent years as business investment has declined and internal

TABLE 16–2

GROSS AND NET NEW ISSUES—SELECTED YEARS[a]
(Par value in millions of Canadian dollars)

	1946		1951		1956		1962	
	Gross	Net	Gross	Net	Gross	Net	Gross	Net
Canadas and Guarantees	984	137	578	−458	1,527	−616	3,442	521
Provincials and Guarantees	133	−2	419	250	635	540	1,088	661
Municipals and Guarantees	150[e]	−5	250[e]	176	355	224	509	215
Corporate Bonds	581	−8	438	293	1,042	792	765	315
Other Bonds	n.a.	n.a.	n.a.	n.a.	15	6	12	−2
Preferred Stock[b]	89[e]	−14	29	−15	190	175	87	65
Common Stock[b]	83[e]	81	208	207	514	514	251	250
	2,020	189	1,922	453	4,278	1,635	6,154	2,025
Total Less Canada and Guarantees	1,036	52	1,344	911	2,751	2,251	2,712	1,504

[a]Excludes treasury bills, treasury notes, deposit certificates and commercial paper.
[b]At offering prices.
[e]Estimated.
SOURCE: *Bank of Canada Statistical Summary.*

resources have grown, and the expansion of government issues as deficits have increased and government enterprises have become more significant. It also shows the relatively small share of equity issues in the total, reflecting the fundamental preference of corporations for debt financing when their position will allow it, the tax factors related to the non-deductibility of dividends referred to earlier, and the increasing dependence on retained earnings as a source of equity capital.

The investment dealers are normally more than conduit pipes through which paper moves from borrower to lender and money flows back. The extent of their participation can vary enormously, being comparatively small in the preparation of a routine rights issue and relatively large when a small company is coming to the market for the first time. In the latter case, the underwriter may provide very extensive advice about the financial structure and affairs of the company, the type, timing and size of issue, and its yield, terms and the class of buyers to whom it should be sold. Not surprisingly, the cost of this service is commensurate with the effort and risk and may even run as high as 10% to 20% of the gross value of a small issue. However, the most common role of the dealer in public underwritings and private placements is that of providing advice on the price, terms, and other conditions of the issue.

The most prevalent type of underwriting on this continent is a firm commitment underwriting in which the underwriter buys the whole issue, takes the risk of selling it and obtains his compensation from the difference between the price paid to the borrower and that at which it is sold to the public. The issue may be negotiated or won at an auction. The option underwriting, under which the issuer grants the underwriter a series of options on blocks of unissued stock in exchange for a firm commitment on one block, is used mainly in mining finance and will be discussed in the next chapter. However, on smaller municipal issues particularly, the dealer may take an option on the whole issue good for a limited period; if he finds interested buyers he will then purchase the securities. The dealer may also act purely as an agent, using his best efforts to sell an issue in return for a commission on sales actually made or helping the borrower to find a source of funds and to negotiate reasonable terms with the purchaser, usually one or a few large

financial corporations. By using these direct placements, costs are minimized—the issue usually being exempted from registration and prospectus requirements under the securities acts —and terms can be specifically tailored to the borrower's requirements. In certain circumstances the covenants may also be easier to renegotiate although the lender is often in a good position to drive a hard initial bargain on rates and terms. While in the United States about 50% of all corporate issues are privately placed, half of them without dealer assistance, this form of raising funds is less common in Canada and the advice of a dealer is usually sought.

Virtually all corporate issues and an increasing number of provincial and large municipal issues are marketed by firm commitment underwritings negotiated with a fiscal agent. The usual procedure is that the borrower first contacts the dealer or dealers with whom it has a continuing relationship or agreement and discusses the nature, timing and terms of the issue and whether it will be a market issue or a direct placement. If the issue is not exempted under the securities acts, the necessary prospectus, trust indenture, balance sheet and other documents will be prepared and the registration procedure initiated. When the issue is almost ready for market the banking group, which is almost always the same group of dealers for every similar issue of that borrower, will be notified and its participants asked to accept their traditional portion of the liability. The firm agreement setting out the terms of the underwriting will subsequently be signed and in a day or two, or even on the same day in some instances, approaches to customers will begin; payment and actual delivery of the securities will be made two to three weeks later. Particularly if the issue is large, a selling group might also be formed, the dealers in which enter firm orders as principals, subject to allotment, on which they receive a commission or discount. In fact, then, the full liability for the issue is taken by the syndicate manager who in effect simultaneously spreads it to the banking and selling groups. For a non-exempt issue the whole process might take anywhere from three weeks to several months, while for exempt securities like government issues the elapsed time may be 10 days for a small municipal offering and as little as three days for large provincial issues. The typical procedure in the latter instances is for the syndicate manager, on first hearing of the intention of the government to raise money, to consult immediately with the steering committee of the syndicate before the final price is set and the agreements are signed. If an issue is being offered by tender, as most municipals are, the syndicate as a whole, or its leading members, will meet to discuss the bid that is to be submitted.

While this system is effective in spreading risks and distributing issues, it has problems associated with it. Perhaps the greatest of these is the rigidity it introduces into the industry. Syndicates once formed tend to ossify: the new firm finds it almost impossible to obtain participations, while the aggressive and growing members of the syndicate experience equal difficulty in expanding theirs. Participants in syndicates, particularly of corporate issues, also complain that they are seldom seriously consulted, often being given less than 24 hours to decide whether or not they will participate. Given the lack of flexibility in syndicates, they usually must go along whether or not they believe the issue is attractive, since rejection means they will not be invited to distribute subsequent issues. It is also traditional in Canadian underwritings for the syndicate manager to set aside from 40% to 60% of the issue for sale on behalf of the syndicate to the selling group and large institutions. These institutions make up what is known in the business as the "exempt list" and can only be approached by the syndicate manager or dealers authorized by him. This further strengthens the position of the managers with the institutional buyers and other syndicate members, although it helps to prevent the institutions from being inundated with selling offers during the issue's distribution period. It is also designed to prevent powerful buyers from playing the sellers off against one another in an attempt to break the minimum issue price specified in the banking and selling group agreements.

Syndicates in the United States are much more flexible, although they were not always so. This is partly because adherence to the Securities and Exchange Commission's net capital requirements occasionally makes it necessary for a heavily committed firm to decline invitations. Issues are also much more frequent and the number of syndicate managers much larger so that rejection of a participation does not have the consequences for a firm's present and future revenues that it does in Canada. More important, however, the size and impersonality of the American market tend to make price factors more important and to lead to less emphasis on reciprocal business. Houses with a good record of placing their participations will thus be invited to participate in subsequent issues even if they declined the last time, margins are slim enough to discourage some of the inefficient firms, and the managers deal comparatively ruthlessly with poor performers. We hope that a similar flexibility will develop in Canada, particularly since the industry is now large enough to allow more impersonal and competitive forces to work without impairing the service provided to the borrower.

The present Canadian system puts enormous power in the hands of the relatively few main syndicate managers. Since these firms participate in one another's syndicates and since other firms are reluctant to compete with them for a large issue because of fear of losing their participations in all the syndicates managed by them, competition for corporate, large municipal, and provincial underwritings has been modest and the constant lobbying of the better syndicate members for increased participations has been relatively ineffective. Some "sniping" does indeed go on, but competition has tended to take other forms, such as the provision of money market services and information and advice about securities and commodities markets. Part of the responsibility for this state of affairs must lie with the issuers, who are reluctant to switch fiscal agents on price or service grounds. Indeed, in some instances the issuer insists that the participations of existing syndicate members be left unchanged even though they do not properly place their allotments. The recent moves by some members of the industry to make room for expanding and more effective firms by cutting back on the syndicate allotments to poor performers are to be commended. The issuers themselves can assist in this development by taking a closer interest in the record of distribution of the individual members of the syndicate.

The advantages and disadvantages of having the chartered banks in syndicates were discussed by the I.D.A. in their brief to us. By supplementing the capital and retail distributing power of competing groups of dealers, such bank participation —which is mainly confined to municipal and provincial issues—can play a useful role. The investment industry does not seem to have been weakened by this practice and so long as the dealers remain alert and aggressive, there is no reason why it should be. However, if the banks remain in this field they should do so as open partners sharing full responsibility with the other underwriters to the investing public. At present the banks are shielded from this responsibility by the Bank Act, Section 157(2) which prohibits the appearance of a bank's name in a prospectus or advertisement for the sale of securities other than those issued by the Government of Canada. We believe this provision should be amended so that the banks can be required to comply with the disclosure requirements imposed on other underwriters by the securities legislation. In order to prevent unscrupulous use of a bank's name to sell securities, the original reason for the section's adoption in 1944, the section might continue to prohibit the use of a bank's name in a prospectus or advertisement when it is not an underwriter, except when the bank gives its express consent. Although removal of the present restriction might increase the participation of the banks in the distribution of securities, the dealers will continue to be in a better position to advise both borrowing and investing clients. Moreover, bank managers, with their many other responsibilities, are not likely to try to become experts on security sales which reduce their own deposits.

The reasonableness of underwriting costs must be considered in any assessment of whether the new issue market serves borrowers well. The cost of registration with the various securities commissions averages about $200 including the fee for the legal opinion on the validity of the issue. More significant are other legal fees, which for some complex debt issues might run as high as $30,000, the trustee's fee, the cost of an audit if one is required, printing costs for the certificates, and possibly engineering and other costs for technical advice and services. The total cost, excluding the payment to the underwriter, is likely to fall between $15,000 and $50,000 and most offerings cost between $25,000 and $30,000. Current data are not available for the United States but a Securities and Exchange Commission study published in 1957 estimated that an industrial debt issue of $15 million would cost about $100,000, excluding the underwriters' charges, or about twice the maximum Canadian cost today. The costs for government issues are, of course, very much lower and are not significant in total.

The largest single cost in floating an issue is the compensation to the investment dealer. This cost sometimes includes payment for continuing advisory and market services not directly related to a specific underwriting, although a separate charge is occasionally made for such services. The underwriter's internal costs are to a large extent fixed regardless of the size of the issue and may even be higher for preparing a complex small issue of a company new to the market than for floating a routine large issue of an established company. Moreover, the market risk is often related to the size and newness of the company. Until recent years the underwriter paid for his own legal advice but the issuer now usually pays this cost, partly because a 1955 amendment to the Income Tax Act, (Section 11(1)(cb)) allowed expenses incurred for the issue and sale of securities to be deducted from corporate income for tax purposes. The amount paid to the underwriter is, however, not deductible, a subject on which we received representations but which we believe is better dealt with by the Royal Commission on Taxation.

Comparisons of the results of an American study of 1951-55 underwriting costs[5] with Canadian data for the same period indicate that Canadian spreads were generally wider for large issues, but were typically lower on smaller issues. Spreads in Canada do not appear to have altered significantly since that time and usually range between 2% and 3% on good corporate issues, between 3% and 5% on sound but less well-known companies, and between 5% and 10% or higher for unproven companies. In the United States on the other hand, spreads have narrowed perceptibly. Although spreads on U.S. public utility issues remained consistently below 1% and averaged about .8 percent in 1961, the underwriting costs of industrial issues had declined to under 1% in the same year. Canadian spreads for good corporate debt issues, therefore, now appear to be between 2 and 3 times those in the United States. The underwriting costs of Canadian equity capital when issued through rights to shareholders appears to compare favourably with those in the United States, averaging between .5% and 1.0%; any unsubscribed shares are either underwritten for a slightly higher fee or sold by auction. Underwriting spreads for most provincial issues are normally in the range of ¾% to 1¼%. For the larger municipalities they range from 1% to 1½% moving upward to as much as 4% for issues of poorer quality on which bidding is not intense. While difficult to compare with American spreads, the underwriting costs of provincial issues seem to be about the same as comparable American issues, although higher than some big American issues sold by competitive tender, while many municipal spreads in Canada compare favourably with those in the United States.

These generally higher underwriting margins in Canada, especially on corporate issues, are explained in part by the relatively greater importance of the retail market in Canada. It has been estimated by the industry that between

[5] S.E.C. Study, *Cost of Flotations of Corporate Securities, 1951-55.*

40% and 60% of many Canadian issues might be marketed to individual clients who are more costly to service.[6] The other major reasons for our higher spreads are undoubtedly the high degree of concentration of underwriting power in Canada, the comparative lack of competitive bidding for new issues (except for municipals where Canadian spreads, significantly, are usually lower), and the general failure of the industry to engage seriously in competition for underwritings.

It is not possible or desirable for every borrower to offer his new issues by competitive auction. For example, the advantages of continuing professional advice and of building up client interest in the securities concerned are obvious in the case of a small company coming to market for the first time or when the requirements of a corporation are complex. The advantages are less clear when a large company with experienced financial officers comes regularly to market with issues of a routine nature, especially since market consultants can be hired separately. As we indicated in Chapter 4, we believe that the benefits of having a permanent fiscal agent and underwriter can be over-emphasized and that the dealers' willingness to make secondary markets is not purely a function of permanent fiscal agency relationships. Most corporate debt issues carry sinking funds which serve to provide market support and which would still be available if there were no permanent fiscal agency arrangements. We thus find it surprising that corporations and utilities virtually never use tendered underwritings in Canada, particularly when this method, which is obligatory for most American public utilities, seems to be so effective in reducing underwriting margins in the United States. If auctions were held even occasionally, it would make for better prices and reduced costs, serve as a benchmark for companies that might prefer to negotiate their issues, and provide more opportunity for the newer and smaller investment houses to expand and develop—provided that they were sufficiently strong and competitive to win and distribute these issues successfully.

As an alternative to competitive auctions, borrowers have sought to reduce underwriting costs by other means. For example, two provinces have underwritten their own issues, paying the dealers only a selling commission for distributing their bonds. In the corporate field particularly, direct placements with financial institutions have become more significant, partly as a means of reducing the payment to the dealer although also to avoid registration and prospectus expenses. Moreover, rights issues, which also substantially reduce payments to dealers, and in certain circumstances are exempt under the securities acts, have become a much more common method of obtaining new equity funds. On the other hand, there has been a movement away from tendered underwritings by the provinces and the larger municipalities. There may be some justification for this when issues are unusually large, but we think the Canadian industry is sufficiently large to support at least the occasional auction of such issues, if only to ensure that underwriting spreads do not get out of line. We recognize the danger that over-enthusiastic bidding by weak syndicates may lead to an unsuccessful issue and consequent repercussions on the borrower's credit standing. However, this can be guarded against to some extent by requiring proof from bidding syndicates that their capital is adequate or by requiring a reasonable deposit when a bid is submitted.

In general, we conclude that the nation would benefit from more competition in the underwriting field and that—judging from the anxiety with which dealers try to increase their participation in syndicates and by the level of profits in the industry generally—underwriting spreads could be reduced somewhat without fundamental damage to the industry. However, we would not want to leave the impression that underwriting costs are so excessive as to impair the basic workings of markets: a reduction in margins,

[6] Based on Bank of Canada figures for distribution of non-federal bond holdings, however, the average of all issues held by Canadians other than the main financial institutions is closer to 30%; the comparable federal figure is a little higher.

while representing a very worthwhile cash saving to the issuer, would have only a minimal effect on the annual yield cost of a 20 year issue.

There are three further areas of the Canadian underwriting business where some change could improve resource allocation and the functioning of the markets. First, there appears to be a tendency for the large well-capitalized firms to avoid sponsoring riskier enterprises. While most companies of this type do succeed in finding a sponsor, particularly among the smaller and more aggressive houses, the capital available for this kind of underwriting is relatively small and the costs of issue are probably higher than they would be if the large firms participated actively in the business. The large houses apparently feel that having established their reputation as high grade bond houses dealing only in investment-type securities, their business would be harmed if they dealt in riskier issues. They also feel that their high overhead costs effectively prohibit them from undertaking small underwritings on reasonable terms, and are reluctant to charge high percentage fees. This reason may be relevant at times when an additional underwriting will tax the underwriter's physical or financial resources, but does not hold true on those frequent occasions when a firm's underwriting resources are not being fully utilized in the preparation of higher-quality issues and when the costs of employing them in other directions are consequently low. The first objection is perhaps more understandable, although it is not uncommon for clients of even the most conservative houses to want to include some speculative issues in their portfolios.

Fortunately, there are a number of small firms which are not so concerned about their corporate image and have less compunction about charging what they think their services are worth. However, because of the high costs of preparing an issue for market, even these firms rarely take industrial underwritings of less than $250,000 and their spreads can climb as high as 20%. Indeed, very small corporate issues are not appropriate for market distribution, and their needs can be better met by term loans from banks or other financial institutions or by specialized development companies. We believe, however, that the larger underwriting firms might usefully play a more active role in seeking to obtain capital for firms with issues in the $250,000-$1,000,000 range. Some in fact are now doing so on a private placement basis and we hope that this trend will be carried further.

The second weakness of the industry is its reluctance to take on true underwriting liabilities for any extended period of time. Agreement between the underwriter and the issuer on the pricing of the issue is normally only reached at the last possible moment, although the general range will have been established earlier. Moreover, the firm underwriting agreement, which is not signed until the price is fixed, also contains an escape clause which, though seldom invoked, allows the dealer to refuse the issue if the market moves seriously off the agreed price. Finally, institutional and other purchase commitments are often obtained before the underwriting agreement is signed so that the real liability of the underwriter and banking group is frequently negligible. This obsession to dispose of its liabilities quickly, despite the way risks are spread by the syndicate system, sometimes leads the industry to price issues too conservatively at the expense of the issuer or to reduce the size of the issues it will handle. However, the latter problem—which may formerly have contributed to some borrowers making use of the American market—is now less common, and the industry has recently shown its willingness and ability to handle very sizable issues. We hope that in future the industry will gradually develop a longer view towards its underwriting liabilities.

The speed with which issues are disposed of gives rise to a third problem, the lack of time available to the investor to decide whether he will purchase a new issue. Given that the sales force of the industry is mobilized to clear the liability in a matter of days, or even hours, after the issue officially comes to market and that informal purchase commitments may have been entered into ahead of time, some purchasers never hear about such issues or are given only a matter of hours to make their decisions; sometimes,

indeed, a prospectus is not even available to them. These difficulties could be overcome by the circulation of draft prospectuses, known as "red herrings" in the United States, and containing all details but price and yield, well in advance of the official offering date. This procedure assists the American underwriter to judge the demand for an issue and price it more closely to the market as well as enabling the potential purchaser to study the issue carefully. At present, this route is effectively closed in Canada by the way in which "trading" is defined and by the provisions of Section 39(1) of the Ontario Securities Act, although—as we have indicated—some market testing goes on with the bigger institutions.

The risk involved in the use of the "red herring" prospectus is that it might contain incomplete or misleading information. Although such defects would almost certainly be remedied in the subsequent registered prospectus and reputable firms would be sure to draw attention to them, fringe operators might not be so ready to do so. However, such abuses could be controlled by giving the securities commissions the power to take "stop order proceedings" similar to those in the United States whenever any material deficiency is discovered either in the draft or the final prospectus. Where such an order is issued, the offering cannot lawfully be made or continued until the registration statement has been amended to cure the deficiencies and the S.E.C. has lifted the stop order.[7] In addition to the embarrassment of having a stop order issued, the company's prospectus moves to the bottom of the queue of applications for registration. The effectiveness of the procedure is demonstrated by the fact that only 6 of 1,830 registration statements filed with the S.E.C. in the fiscal year ending in June 1961 were placed under stop orders.

All these factors considered, the case for the use of red herring prospectuses in Canada is a strong one. We therefore recommend that the necessary amendments and additions to the legislation be made. Such changes would also help to co-ordinate the timing of new issues in an informal way, a function that is now performed by the major underwriting houses which, by consultation, can usually avoid having two large issues come onto the market at about the same time. The Bank of Canada does have a system whereby it will indicate to a province upon request whether or not a particular date in the future appears to be available for a new issue, but some people urged us to consider a more formal and public method of co-ordination of new issues. However, such measures would only be feasible if the co-operation of all the major borrowers were received or if some central authority were to be given powers to defer issues and assign priorities. It is doubtful whether control to this extent is either possible or desirable. Nor does the problem seem likely to be a serious one, although it might be helpful to all borrowers if the federal, provincial and large municipal governments were to announce the general nature and timing of their borrowing programs in advance.

We have not discussed the subject of new issues floated in the American market in this chapter since the matter is dealt with elsewhere. The dealers play an important role in advising borrowers whether to resort to such external financing and, given the close links between the Canadian and American markets, are very sensitive to differentials in interest costs and in the availability of funds. New issues in foreign markets are underwritten in much the same way as domestic issues, with the exception that private placements are more common and that syndicate participations are usually divided between Canadian underwriting houses with American operations and United States firms with experience and placing power, particularly in the institutional market.

Finally, we wish to deal with the representations we received that undesirable conflicts of interest arise between the underwriting and other activities of dealers. The investment dealer by becoming a director of a firm with which he has a fiscal agency agreement or understanding places himself in a position to use insider knowledge for his own benefit and perhaps contrary to the interests of the other shareholders. The advantage

[7] Section 8 (d) of the United States Securities Act of 1933.

to this arrangement is that the dealer can seek to influence the management of the company in ways which help to protect his clients' investment. However, he can always obtain information by contractual arrangement with the issuer in any event and would have to be kept informed if he were engaged as a market consultant. While there are thus some advantages to shareholders not being represented by directors who have fiscal agency ties with the company concerned, there are also disadvantages, and we do not feel that there is a need for legislation prohibiting investment dealers from acting as directors of any company of which they are fiscal agents. Any abuses arising out of such relationships can be dealt with under existing laws or through the legislative powers we will propose in the next chapter.

We have also considered the potential conflict of interest resulting when the dealer acts both as an agent and a principal, that is, when he may be merely bringing together buyers and sellers and dispensing objective market advice to clients at some times, while at other times he may be making sales to clients out of his own holdings. The securities administrators and industry associations have taken action to require their members to indicate to the customer whether they are acting as principal or agent so that he may be aware whether or not the advice he receives is fully impartial. Obviously, it is not in all cases—if only because a firm tends to become enthusiastic about the issues it knows best—but we could find no indication of abuses so prevalent and substantial as to warrant the major disruption of the securities business that would result from the enforced separation of jobbing and underwriting on the one hand and brokerage functions on the other.

SECONDARY BOND MARKET

Securities, once underwritten and distributed, trade in the ordinary way through the secondary market. The existence of this market, by enhancing the transferability of securities and serving as a guide to values, makes the primary new issue market a larger and lower-cost market than it would be in the absence of such after-trading. Trading in the secondary bond market is informal, the main dealers in each major city being linked for the most part by direct telephone communications and, quite frequently, by direct lines to their own head offices. While geographically dispersed in the sense that trading is carried out in all the main population centres, the main trading, residual demand and supply, and virtually all dealer inventories are concentrated in Montreal and Toronto.

Statistical information about the secondary market, other than comprehensive data on prices and yields, is practically non-existent. However, the I.D.A. compiled some special sales and inventory information for us from a survey of its members, some of which is set out in Table 16-3. While these data lack precision and the figures should only be taken as representing orders of magnitude, they clearly indicate the preponderant role played by Government of Canada securities in the dealers' secondary market sales: 80% of total transactions were in Canada's, almost 70% in money market issues alone. Treasury bills accounted for much of this volume, with dealer sales being equal to about three times the amount outstanding. Dealer turnover of Canada bonds beyond the money market range drops substantially, with some of the sales representing sales to government accounts like the Securities Investment Account and the Purchase Fund. Dealer secondary market activity in provincial and municipal direct and guaranteed bonds and in corporate bonds was equivalent to an even smaller proportion of total bonds outstanding, with sinking fund activity perhaps accounting for between 10% and 15% of total trading of the provincials and corporates.

A wide variety of factors determine whether or not an issue trades actively in the secondary market and thus whether it is a relatively liquid or shiftable instrument in the hands of its holders. Other things being equal, large issues with a widespread distribution are more likely to have a good and continuing market than smaller issues: the existence of substantial numbers of potential buyers and sellers means that the bigger issue

TABLE 16–3

SECONDARY MARKET SALES[a]

—	Amount Outstanding[b]	Secondary Market Sales	Relationship of Market Sales to Bonds Outstanding	Distribution of Secondary Market Sales	Distribution of Investment Dealer Inventory[c]
	$ millions	$ millions	%	%	%
Government of Canada:					
Treasury Bills	2,165	6,507	301	37.4	28.6
3 years and under	4,176	5,532	132	31.8	34.4
3 years to 10 years	3,249	742	23	4.3	2.3
Over 10 years	4,856	1,212	25	7.0	4.6
Provincial Bonds	7,156	1,225	17	7.0	9.5
Municipal Bonds	3,090	388	13	2.2	3.1
Corporate and other Bonds	5,958	1,163	20	6.7	9.8
Finance Company and Commercial Paper	n.a.	654	n.a.	3.8	7.7
		17,421		100.0	100.0

[a]Table based on secondary market sales made only by members of I.D.A. during their 1962 fiscal years.
[b]Gross amounts outstanding as at December 31, 1962—direct and guaranteed market issues payable in Canadian dollars.
[c]1962 fiscal year-ends—excludes stocks.

SOURCE: Submission of the I.D.A. and *Bank of Canada Statistical Summary*.

can be traded in large volume without moving the price unduly. Trading spreads are thus narrower than for a smaller issue, a factor which in itself encourages trading; for example, the spreads on the large Canada Conversion Loan issues of 1972 and 1983 are typically ¼ of 1% to ½ of 1% narrower than on many of the smaller and more closely held surrounding maturities.[8] The existence of a sinking fund also adds to the marketability of an issue, not only through its own operations but because its existence makes others more willing to trade in the belief that there will always be some support for the issue. However, the existence of such funds does not by itself make an issue trade actively, as the turnover figures on corporate and provincial bonds attest. The original method of distribution also plays a role—bonds privately placed with institutions rarely trade, while those available only in large denominations never attract a widespread retail following. On the other hand, issues convertible into common stock may be very active traders, particularly in a period of rapidly changing equity markets, while bonds selling at a substantial discount may have an active market among those in high tax-brackets.

Perhaps most important are the attitudes and motives of the holders. Thus we find many short-term bonds trading actively as much because the holders regard them as liquid as because of their comparatively low risk of capital loss. Conversely, municipal issues, and many corporate and provincial issues as well, are illiquid mainly because they are bought by long-term holders not interested in short-term trading; in the case of municipals, the serial feature, odd denominations, and small amounts often involved add to this lack of liquidity. With the exception of the securities of the larger provinces and their hydro-electric commissions, a few of the larger municipalities and some of the bigger corporate issues, therefore, virtually no secondary market exists for this type of obligation. Spreads might be as wide as one or two points for well-regarded provincial issues and two to four points for comparable corporate securities, while the market will be confined to a comparatively few dealers.

[8] The bid and asked spreads used here are retail or publicly quoted spreads. Spreads for "inside" trading are much narrower but the same relative differentials appear.

Another important determinant of the closeness of market spreads and trading activity is the willingness of dealers to carry inventories and establish short positions from which they can meet client orders when there is a temporary imbalance of supply and demand in the rest of the market. Dealer inventories have grown substantially in the last decade and this has contributed greatly to the improved functioning of the market. At the end of their 1962 fiscal years, members reporting to the I.D.A special survey had total long positions of $485 million compared to only $46 million eleven years earlier, while short positions had grown to $35 million from $9½ million. This growth has been due to a number of factors, among them the development of the money market, the growth of dealer capital and skills, a more enterprising attitude in the investment community, and the maturing of the market generally. This is a welcome trend which we hope will continue. As the earlier table shows, the distribution of inventory tended to be broadly similar to that of secondary market sales.

Better markets are made if dealers are also willing to take short positions, either to service customers or to speculate on future market developments. Dealers are still comparatively reluctant to take such positions despite the trend of recent years, and almost half of such short positions are in fact in treasury bills and other money market securities. If an issue is not liquid, some dealers are unwilling to sell short because of the difficulty they might have in buying the bonds later, a factor which itself contributes to the issue's lack of liquidity. Moreover, the cost of borrowing issues appears to be a factor inhibiting short sales, although more financial institutions are now willing to earn a return by lending dealers bonds against appropriate collateral. We expect to see short positions gradually built up as the market develops and becomes more experienced.

In general, we have no reason to believe that the secondary bond market fails to allocate resources well or that it puts yields on issues which are fundamentally out of line with the risks and costs involved. In earlier chapters we noted that this might not be so true of some of the smaller and less well-known municipalities (although part of the responsibility for this state of affairs lay on provincial governments failing to make more information available about such localities). We also pointed out that some smaller enterprises might find the terms of issue too expensive although this is not a general problem. The market has also shown itself to be sensitive to changing demand and supply conditions, and yield differentials on the various types of securities seem to reflect these conditions; for example, the differential between government and corporate bonds has narrowed substantially in recent years as the government demand for funds has risen and corporate demand has fallen substantially from its peak in 1956-57. Moreover, markets seem to have adapted well to changing conditions, with new types of securities being designed to take advantage of changing investor demand—for example bonds with warrants to purchase common shares and convertible securities. New covenants have also been devised to meet the requirements of institutions and the public: examples include the assignments of production contracts incorporated in the securities which financed the development of the uranium mines and some of the oil and gas enterprises in Western Canada, and the clauses which protect the investor against refunding issues at lower rates of interest.

The market has also become better informed and made more information available to the public. Although there is no single trading board where current prices are posted and available to the public, any dealer stands ready to provide his quotations for the most commonly traded issues at any time: most bank branches also provide this service to their customers. The dealers, through their association, also publish daily press quotations, although they seem somewhat wider than many dealers actually quote; they may thus provide some shelter to the least efficient members.

There is inadequate statistical evidence to analyse the market effects of dealer inventory speculation. There is some tendency for dealers' inventory to reach peaks just before the treasury

bill rate begins to move upward and to decline during periods of rising rates; inventory peaked, for example, in the early part of 1962, while by the time the rate had reached its peak in mid-July dealer inventory had been reduced from approximately $519 million to $342 million. In this period, dealer speculation reinforced the trend of rates and had the effect of assisting the monetary authorities to bring about the desired change in credit conditions relatively rapidly. Dealer holdings of longer term bonds, although a small proportion of the total, dropped particularly rapidly, and—as is typical in such periods—dealers quoted wider spreads in an effort to protect themselves against acquiring unwanted inventory.

At other times, however, dealer speculation can play a less constructive role: with ready access to bank and non-bank funds, some dealers—including dealers and brokers who do not normally carry large inventories—are tempted to over-extend themselves in periods of monetary ease or of apparently successful new Government of Canada issues. This happened in early 1958, and contributed to the subsequent sharp drop in bond prices in that year, and again in late October 1962 when anticipation of a decline in the bank rate drove dealer inventory to what was then an all-time peak of over $540 million. The Cuban crisis intervened before the bank rate was reduced and, on the theory that in troubled times one ought to be in cash, the dealers panicked and dumped bonds worth over $100 million into the Bank of Canada. A similar situation developed in July 1963 when uncertainty developed over the impact of proposed U.S. taxation on new issues sold in the New York market and trading in the Canadian market came to a virtual standstill until the central bank's reaction was known.

While the secondary market is not yet fully matured, is still at times excessively dependent on support from the Bank of Canada, and occasionally displays signs of unthinking conformity to prevailing sentiment, these characteristics are to be found in varying degrees in financial markets everywhere. When formulating their own policies, dealers should, of course, take into account economic and financial developments and the central bank's probable reaction to them. In a maturing market, the participants become increasingly able to "see through" short-term factors and willing to act on the basis of their own judgments. Significant progress in this direction has already been made and the markets have become sturdier and more independent of the need for continuing official intervention. The dealers and markets have also shown themselves able to withstand falls of about 15% in the value of long bonds within a year, although understandably not without some effects on trading volume and profits. We are confident that the markets will become more highly developed in the years ahead.

SHORT-TERM MONEY MARKET

The Canadian short-term money market is a relatively new development which, under the encouragement of the Bank of Canada, has grown and diversified enormously in the last decade and has now become a mature and reliable component of the broader capital market. There are currently 15 money market dealers, of which between 4 and 6 do the bulk of the business. The Bank of Canada grants a line of credit to these dealers, after establishing that their capital is adequate to the volume of business done and that they are capable of making continuous and broad two-way markets in money market securities. These lines, which amount to some $300 million in total, enable them to borrow from the Bank of Canada against eligible Government of Canada securities at a penalty rate (currently Bank Rate or ¼ of 1% above the yield of the latest average tender for 91 day treasury bills, whichever is less) and thus encourage them to carry substantial inventories in the knowledge that financing will always be available. More important, however, these credit lines entitle them to obtain day loans from the banks, callable before noon on any day by either party; rates on these loans are low because of their liquidity, because they are included

in the banks' secondary reserves, and because the banks know that dealers can always resort to central bank accommodation if necessary. The money market dealers, with these primary sources of funds, have played a significant role in developing other sources of funds, as we have already noted. They have also brought other borrowers into the market and educated a wide range of governments, financial and non-financial corporations, and charitable and other institutions in the use of its facilities. Thus the alert treasurer may use the market to borrow or lend for any period from one day to three years and has a wide range of alternative outlets in which he can keep temporarily surplus funds invested at a worthwhile return.

Since the market is highly competitive and relatively impersonal, it has tended to keep dealers' commissions to a minimum and force both them and the banks to devise new methods of attracting deposits. The relatively inexpensive funds provided by the banks and country banks, by encouraging dealers to carry larger inventories, have led to more active markets in federal treasury bills and short-term bonds, to a reduction in dealer spreads, and thus to an increase in the liquidity of these and similar instruments. In addition, the development of a series of short-term instruments of other borrowers with competitive rates has broadened the range of instruments which are sensitive to general credit conditions. An important section of the business and investing community has thus been made more aware of general monetary conditions and day to day changes in interest rates. Some treasurers have used this knowledge to introduce more flexibility into the timing of their approach to the market for long-term capital, adjusting their short-term lending and borrowing in the meantime.

The development of the money market has provided the Bank of Canada with a notably improved vehicle for its own operations. Prior to 1954, the Bank's activity in the treasury bill market was severely restricted; the market was thin and most of the bills were held by the chartered banks and were only traded directly with the central bank. Today this market has all the advantages resulting from the existence of substantial dealer inventories and a large and diversified group of buyers and sellers, and the Bank can now carry out sizable open market operations by acting through the 15 jobbers as well as the banks. Moreover, the effect of these transactions is more widespread and more speedily transmitted than could have been the case prior to 1954 since previously compartmentalized pools of funds have now tended to flow into the central reservoir of the money market.

The history of this market, has been well described elsewhere[9] and we shall accordingly restrict our discussion to the more recent development. By 1958, the initiative of the Bank of Canada and the active co-operation of the jobbers and banks had developed a broad market in federal government treasury bills and short-term bonds. Dealers had also become active in marketing the short-term promissory notes of instalment finance companies which turned increasingly to this market because of the uncertainty of chartered bank lines of credit and the rigid and relatively higher cost of bank lending rates. Finance company paper outstanding rose from $16 million at the end of 1949 to $118 million at the end of 1951, which was the year of the first post-war freezing of their bank lines, and continued to expand until by mid-1962 approximately $500 million was outstanding. Most of this paper has been placed through dealers.

Particularly since 1957, a market has developed for the short-term promissory notes of prime non-financial corporate borrowers, and by 1961 this market grew to over $200 million. Currently, the amount outstanding may run up to $450 million; our survey (which excluded governments) showed non-financial corporate borrowing of over $300 million in mid-1963. At that time, there were 51 corporate borrowers including large retailers, grain dealers and a wide

[9] See J. A. G. Wilson, *The Canadian Money Market Experiment*, Banca Nazionale del Lavoro Quarterly Review, March 1958; Bank of Canada Annual Reports; and the Submission of the Investment Dealers' Association of Canada.

range of manufacturing corporations. Virtually all these companies have important seasonal variations in their cash flows and many of them are issuers of notes at one time during the year and purchasers at others. The rate structure for prime corporate paper is comparable to that of finance company paper but is normally about ⅛ of 1% above it, partly because their notes are unsecured. Dealers at first acted strictly as agents in placing this paper, taking a small commission averaging about ⅛ of 1% per annum for bringing together borrower and lender. However, severe competition forced dealers to take the paper into inventory and use it, along with treasury bills, for buy-back arrangements with short-term lenders. The clients for this paper include trust companies who take it into their own portfolios and issue their own liabilities to investors who may only purchase trustee securities. Some of the trust companies also use the dealers to place guaranteed investment certificates on a commission basis but these instruments do not trade subsequently.

Two factors, in addition to the expertise and selling efforts of the money market dealers, have contributed to the development of this corporate paper market. The first has been the relatively high cost of borrowing from the banks at times when credit conditions are easy and the second has been the increased attractiveness of this market to lenders when short-term rates are above 2%. Once accustomed to this market, both borrowers and lenders tend to remain with it as long as there is any net advantage in doing so, even though the original wide differential has disappeared. Moreover, bank pressure on their larger borrowing customers in times of monetary stringency has reinforced this movement, as has the borrowers' experience that funds are virtually always available if the rate offered is appropriate.

Chartered bank competition for short-term funds has been described in Chapter 7. In June 1962, the banks contributed another instrument to the money market, the banker's acceptance, whereby a customer wishing to use market facilities sells a short-term instrument guaranteed by a chartered bank. The minimum denomination for such acceptances is $100,000[10] and the rate is between the treasury bill rate and the rate on prime finance company paper, although the borrower pays the banks a minimum fee at a rate equivalent to 1¼% per annum for guaranteeing the draft. Acceptances were introduced just before the treasury bill rate reached its peak of over 5½% and borrowing by this means would have thus cost considerably more than direct bank borrowing. Although the treasury bill rate has since declined, the development of the market has been miniscule; the differential between the cost of borrowing by acceptance and the bank's prime borrowing rate is still rather narrow, most of the chartered banks lack enthusiasm for this instrument, and larger corporations already have access to the market at rates which are between ½ of 1% and 1% cheaper. However, if interest rates fall still further, the chartered banks' prime lending rate remains insensitive, and a foreign demand for this paper springs up, the acceptance market might yet develop in Canada. Lowering the minimum denomination further, as was suggested to us by a number of witnesses, would entail considerable extra difficulties and costs for the banks owing to the closer supervision which small borrowing accounts require, and to the loss of compensating loan revenue which would be involved. However, if the market expands and more experience is gained, such a development might occur.

Other recent entrants into the money market include the provinces, provincial agencies, and the municipalities. Although provincial government treasury bills have been outstanding for many years, these bills were held almost entirely within the banking system and it is only within the past three or four years that the provinces and their agencies have sold short-term paper in the market. A large amount of this paper has been placed privately and little information is available about it. Some provinces have, however, called for tenders on particular blocks and dealers have participated in the tenders. In early

[10] Until January 14, 1963, it was $200,000. Acceptances are eligible for rediscount at the Bank of Canada, as security for day loans and for inclusion under the 15% liquid asset agreement.

1962, the provinces of Manitoba and Saskatchewan each began to hold regular weekly tenders for $1 million of three-month treasury bills. They were issued in each case to a total amount of $13 million and have been maintained at that level since. While there have been a few cases in which the bid was not accepted by one of the provinces, the experiment seems to have been successful on the whole. A number of the larger municipalities have also entered the money market with tax-anticipation or treasury bills from time to time, and both tendered and negotiated underwritings of these bills have taken place. It has been estimated that approximately $60 million of short-term municipal paper was outstanding in mid-1962, about half of which was issued by Metropolitan Toronto. A number of municipalities entered the market for the first time in that year and the city of Montreal began in September to accept bids on a series of weekly treasury bill issues.

Foreign investment in the money market, particularly by U.S. residents, has been substantial and has contributed significantly to its recent development. Prior to the introduction of the 15% withholding tax in December 1960, most of the interest was in federal government treasury bills. As the calculation of the 15% tax on these bills proved to have a strong nuisance value, foreign interest in them has tended to diminish and more attention has been given to better-yielding finance company and corporate paper where the withholding tax poses fewer problems. Foreign holdings of all short-term money market instruments are estimated to vary between $300 and $500 million in normal circumstances. Four to six dealers in Canada handle most of the foreign money market transactions and a large proportion of their business is channelled through a single bank in the United States which places the paper and hedges the transaction. Indeed, almost all non-resident transactions in this market are fully hedged against the exchange risk.

Ordinarily a hedged spread of about ½ of 1% is required to set in motion international flows of short-term capital. We have noted in the previous chapter that the factors taken into account by the foreign investor include the interest rate differential between domestic and foreign paper, the differential between the spot and forward exchange rates—the cost of hedging—and the trend of interest rates in his own country. Despite the diminution of risk which results from both the short-term nature of the paper and hedging against exchange loss, considerations other than those just mentioned can be important. In the first half of 1962, for example, despite attractive net yields, the flow of U.S. funds was discouraged by the psychological effect of the withholding tax combined with an unsettled federal political situation and fears about our external financial policies. These fears were intensified by the earlier expropriation of a privately-owned power company in British Columbia and the threatened nationalization of similar companies in Quebec. Moral suasion by the U.S. administration against investing abroad also played a part in damping down short-term capital inflows at that time.

Apart from its rapid growth and development, perhaps the only discernible trend in the money market is the diminishing use of dealers in commercial paper transactions. In the United States in the 1920's virtually all commercial paper was placed by dealers, but by 1935 companies had begun to place this paper directly among themselves. Although halted by the war, the trend has resumed since, and directly placed paper now amounts to more than three times that placed through dealers. A similar trend seems to be starting in Canada as borrowers and lenders become more experienced and more familiar with one another, although in view of the newness of the market it will probably be some years before the American situation is reached.

The short-term money market has had a remarkably trouble-free development and has evolved into a smooth mechanism for transferring short-term funds from lenders to borrowers. It has increased the number of participants in such flows and allowed the banks to

transfer cash among themselves quickly and easily, albeit indirectly. Rates in the money market seem to be highly flexible, and although not all banks seem to take full advantage of it at the margin, it has enabled them to run very close to the minimum cash requirement and thus greatly simplified the task of the monetary authorities.

One source of potential difficulties has, however, arisen in the commercial paper market, partly because borrowing for terms of less than one year is exempt from the disclosure requirements of securities laws. The available information about corporations entering this market is therefore sometimes restricted to that contained in their annual reports, or, in the case of private companies, to virtually no financial data at all. Since there is no official rating service to evaluate the credit worthiness of borrowers, the burden of responsibility for insisting on the provision of adequate data and its evaluation must be borne by the dealer and purchaser. In some instances, a proper evaluation may not have been undertaken, although this can be easily and cheaply done, while in others dealers have found it difficult to refuse to market paper offered by a client whose financial position might lead to difficulties in adverse circumstances.

While the potential risks in the unregulated growth of this market must be recognized, the participants in the market are likely to continue to be sufficiently sophisticated to protect themselves. However, we believe that the Bank of Canada ought to interest itself in a general way in the quality of paper being handled by the money market dealers and ought to feel free to draw attention to any serious weaknesses if these should ever develop. While we are not recommending central bank intervention in the dealers' affairs, and indeed have found no evidence of such intervention, we think it only reasonable that the central bank should continue to ensure that those to whom it extends borrowing privileges remain financially sound and otherwise qualified to remain useful and reputable money market participants.

THE CENTRAL BANK AND THE MARKETS

The Bank of Canada in its brief to us stated that one of the objectives that affects its choice of techniques for implementing monetary policy is its "desire to encourage the development of broad, self-reliant markets for Government securities".[11] Such markets serve as reliable guides to credit conditions and help to transmit the effect of policies smoothly and quickly to all sectors of the economy. They are usually characterized by active trading, close spreads between bids and offers, active arbitrage which transmits changes in one maturity range quickly along the whole yield curve, and by the absence of erratic changes in the direction of market yields. The Bank of Canada has tried to encourage such developments, not only through its facilities for the money market dealers, but in facilitating the movement of securities across the country and by making more market information and statistics available so that informed and intelligent trading and speculation can take place. It has also, as the federal government's fiscal agent, attempted to increase the number of debt-holders and thus the breadth of buying and selling interest in the market. Finally, it has privately encouraged the industry to build up its capital which, as we have seen, is now relatively above that of the United States government bond dealers.

While the central bank has in general played a useful and constructive role in this connection, it has not always succeeded in developing effective markets and has sometimes engendered strong distrust by the dealers, particularly by those less familiar than some with the requirements and repercussions of an active monetary policy. In any event, these two inter-related features of reliance upon the Bank and distrust of its operations were clearly reflected in the industry's submission to us and in its evidence at the public hearings. In part, this has been the result of a breakdown of communications at both the trading and policy levels. Until very recently, senior personnel of the Bank have made only infrequent visits to the financial centres of

[11] Submission III—paragraph 23.

Toronto and Montreal and, while dealers have always been welcomed in Ottawa, their visits are often with some specific purpose or complaint in mind and do not provide the closeness or frequency of contacts needed. Moreover, the Bank's market activities have not always been well explained, and from time to time dealers have felt they were capricious.

Some part of the explanation can be found in the central bank's trading practices. The trader in a bond house can, with the flick of a switch talk to his opposites in any one of 30 or 40 other houses and banks with whom his firm has direct telephone connections. Moreover, given his firm's inventory policy, he is usually willing to respond instantly to bids or offers and expects others to do the same. However, his trading relationships with the Bank are quite different. No dealer has direct telephone lines to the Bank, apparently because of the Bank's fears of charges of favouritism, but must instead dial the Bank's switchboard and wait for the trader to return his call in the order in which it was received. Although approximately 80% of the Bank's trading contacts are with the 15 money market jobbers, there are times—particularly in unsettled markets—when 30 or 40 dealers may telephone the Bank and when the delays which result are both long and annoying. Moreover, the Bank's trading operation is dispersed—although linked together by a direct communications system—and the four traders in Ottawa, two in Montreal, and three in Toronto have very limited discretion in responding to bids and offers. Finally, when trading on directions from Ottawa, they are apparently not normally informed about the purpose of the transactions and are thus not in a position to explain the Bank's policy and aims. Since their discretion is limited, and since the Bank has not posted prices since January 1948, preferring for the most part to operate more generally on the level of rates and to let the market sort out individual security prices, the dealer's proposal might well have to be relayed to Ottawa. Although as high a proportion as 87% of dealers' firm propositions are dealt with immediately, the other 13% involved delays averaging 20 minutes and ranging up to more than two hours on occasion. In an industry used to practically instantaneous communications and quick decisions, such delays can prove very upsetting and on occasion are reflected in unnecessary market disturbances.

Trading arrangements are rather different in the United States, where the Federal Reserve System's trading is carried out by the Federal Reserve Bank of New York and centralized in that city. Instructions are handed down by the Federal Reserve Open Market Committee but the Account Manager, a Vice-President of the New York Bank, is given wide discretion within these instructions. Market contacts and information are excellent, and dealers doing business with the Bank may attend 15 minute weekly or bi-weekly conferences with its officers to discuss general conditions and any technical or other aspect of the market related to the firm's operations; most of the active dealers send senior members of the firm to these meetings. The Bank trades only with a select group of 17 banks and dealers (some of them with head offices outside New York) which specialize in government securities; in other respects the position of these dealers is similar to that of the 15 Canadian money market jobbers. The trading techniques of the Federal Reserve are streamlined and efficient, and direct lines to the dealers are maintained to enable it to contact the dealers and receive bids or offers from them in a matter of minutes. If a large purchase or sale is to be made, all dealers are contacted virtually simultaneously by a procedure known as a "go around" which allows the dealers making the most attractive bids or offers to do the business. In Canada, by contrast, the dealer who just happens to be on the line often makes the purchase or sale, although the Bank sometimes solicits bids or offers from a few dealers or limits transactions with any one dealer if it is engaged in a large buying or selling program. The American system, of course, involves a problem of communications within the Federal Reserve and delays are not unknown, but we received the impression that on balance it led to a highly efficient trading operation.

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As early as 1900, a limited number of dealers in the United States had specialized in government securities and in 1920 the New York Federal Reserve Bank began extending repurchase agreements to them. The Bank since that time has found it convenient and efficient to restrict its trading to a limited number of highly-qualified specialists. Since some Canadian dealers are already becoming specialized in positioning and trading Government of Canada issues, the Bank of Canada ought in due course to consider whether its own operations would be made more efficient and the market more self-reliant by confining its trading to a limited, but not unchanging, number of dealers. A first and useful step in this direction might be to give direct lines to houses engaging in a certain minimum of market trading: others would continue to call in as at present. A second constructive measure would be the raising of the minimum size of transaction which the Bank is prepared to undertake (currently this is $250,000 for money market securities and $100,000 for other maturities). When this minimum size was last increased, the number of dealers with whom the Bank did regular business was cut from 110 to 40, and we were informed that doubling the minimum size of transaction would now cut the latter by about half. This would have the advantages of encouraging the market to be more independent in its judgments and of facilitating the Bank's trading operations without in any way interfering with such other market contacts as the Bank wished to maintain, particularly in centres outside Toronto and Montreal. Nor do we believe it would penalize smaller or growing firms since their livelihood and expansion does not depend on trading in relatively small amounts with the Bank of Canada.

Some frustration is inevitable in any relationship between the central bank and securities markets, especially since the monetary authorities cannot always disclose their hand, even when they are certain of their future policy. In fact, central banks are often not exactly certain about underlying economic forces or what state of credit conditions is appropriate to them. Moreover, they must frequently use trial and error methods—known in central banking as "successive approximation"—until financial markets give them more guidance or the results of their previous policies become somewhat clearer. However, we believe that secrecy can be overdone, and that the benefits of frank and full information about monetary and debt management activities are sometimes not fully appreciated by the Canadian authorities. While we realize—as should any informed and sensible participant in the market—that there will be times when major policy decisions or switches require careful consideration and consultations among the Bank's senior officials in Ottawa which necessarily involve secrecy and delays, we are still of the opinion that the Bank's working relationship with the markets can be improved. We will return to this question in Chapter 26 after we have dealt more fully with the operation and effectiveness of monetary and debt management policies. In the meantime, we wish to note and welcome the recent efforts that have been made to improve trading practices and communications with the investment community.

The problem of reconciling the goal of broad, self-reliant markets with the need to establish precise levels of interest rates or to curb excessive market swings from time to time is not an easy one. It is particularly difficult for the Bank to "disengage" after being an active buyer of numerous issues, and to prevent such disengagement being misconstrued by the market. However, a franker discussion of the Bank's aims on such occasions would be helpful, as it would when the Bank is undertaking operations related only to the more mechanical aspects of handling the government's debt. At present, Bank traders tell the market that transactions for the government accounts or foreign clients are "for an account" and the dealers appear to endow this phrase with particular significance. We do not believe the Bank ought to be bound by such rules, nor are they particularly revealing when one considers the close relationship between monetary policy and some aspects of debt management—

a subject we will discuss in later chapters. However, there are undoubtedly frequent occasions when the Bank could be more forthcoming about such matters and could even help to achieve its broader aims by doing so. Given the importance of the Bank's direct and indirect impact on security markets and credit conditions, it is to be expected that the dealers should be strongly influenced by the Bank's view of the economic outlook and the probable response of the monetary and debt authorities to it. However, this does not mean that they should always share the authorities' views, await their moves, or show no independence of judgment. The more information that markets can be given and the more they can be left to work out the pattern of interest rates without undue dependence on the authorities when broader considerations allow, the more useful and effective they are likely to become.

The techniques used to distribute new Government of Canada issues no longer appear to be a source of friction between Bank and dealers. Successive experiments have resulted in practices that seem well suited to the current Canadian market, although we do not suggest that they remain fixed for all time. Indeed, as we shall argue more fully in later chapters, the authorities must be flexible in their debt management techniques no less than in their other operations.

For both political and economic reasons it is desirable for the debt managers to tap as wide a range of buyers as possible. A broadly held public debt contributes to greater public consciousness of government policies and activities and also encourages the development of a broader and more liquid market which may help to minimize interest costs. Finally, wide-spread debt holdings may facilitate the transmission of financial policies throughout the economy. These considerations are reinforced in Canada by the lack of an institutional market as highly developed as in the United States; retail sales to individuals must therefore be relied upon to supply a significant proportion of government funds. In fact, it appears that the proportion of Government of Canada marketable debt held by individuals is almost twice that in the United States.[12] Before mobilizing their extensive branch networks and sales forces which service this retail market, the dealers like to have some indication about the number of bonds they will receive and the timing and main characteristics of the new issue. Reducing the uncertainty surrounding such issues is therefore a particularly important consideration in Canada if full advantage is to be taken of the industry's distribution facilities.

While the Bank of Canada and government accounts effectively underwrite government issues and may subscribe to a portion of them initially, the main distribution is made by about 270 investment dealers and brokers, the eight chartered banks and the two Quebec savings banks—collectively known as the primary distributors. The Bank states that dealer participants are selected only after careful investigation has proven financial responsibility and a record of active and continuous distribution of high-grade securities; geographic distribution is assured by the use of the chartered banks and by the selection of dealers with head offices across Canada.

In most recent issues the Bank has adopted a procedure of offering a portion of the new issue "firm" to each dealer, thus assuring them of a minimum amount of bonds if they accept this allotment in whole or in part. Subscriptions are then invited for the remainder of the issue, but individual dealers and banks may not enter subscriptions for more than twice the amount of firm bonds accepted by them. This is to prevent excessive "padding" of orders which may result in a dealer getting more bonds than he can handle if he has misjudged the percentage of his subscription that will be accepted. When the book is closed, these non-firm bonds are allotted pro rata along with any firm bonds not accepted. Actual delivery and payment are usually made two weeks later.

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[12] We considered the possibility of encouraging the dealers to cultivate this higher-cost market through a two-price system for new issues or a two-tiered commission structure. However, quite apart from the question of whether such methods would be justified or effective, they would lead to abuses which would be difficult and costly to contain.

Prior to any offering, meetings will have been held between the Minister of Finance and his Bank of Canada and departmental advisors at which decisions about the rate, term, method of distribution, commission, etc. are made. Within a week an announcement will have been made by the Finance Department giving some of the general characteristics of the new financing and its offering date, usually two to four days later. This enables dealers to start planning their sales campaign, although the exact size, term, call characteristics, price and yield of the new issues are contained only in the telegrams sent to dealers across Canada before the opening of trading on the offering date itself. These telegrams also describe the commission, which ranges from .10% to .25% on short-term issues to as much as .75% on long-term issues, the dates of interest payments, and the available denominations. In addition, they set out the number of bonds offered firm to all primary distributors as well as to the recipient of the telegram and contain delivery and subscription instructions. Finally, they set out the issue price—the minimum price at which the securities may be offered or sold to investors; this price restriction is usually removed on or before delivery date. In subscribing, the primary distributor also agrees to conform to a series of regulations relating to sales through sub-agents and other matters, and to submit to the Bank a record of all sales of the issue over a period of about a month.

Among the problems associated with this method of distribution are those of pricing the issue correctly, of setting commissions and of choosing the primary distributors and ensuring that the allotment of each fairly reflects his placing power. The role played by the Bank in these matters is formally that of agent for the Minister of Finance. One possible alternative method of issue is sale by auction, which has been used successfully for treasury bills since 1934 but was tried for bonds only on two occasions in the first half of 1960. This system removes the problems of setting prices, allotments, and commissions, and provides the government with the best possible price for that issue. However, it also creates its own problems: for example, the only complete issue offered for tender—the 4¼'s of December 1, 1962—was not well placed. Individual dealers have to guess what the other 269 bidders will do, and the price may be bid up to unrealistic levels as a result, only to fall again later. The dealer is also uncertain about his own price and allotment and reluctant therefore to make a sales effort until after the auction, by which time the initial momentum may have been lost.

These problems would be less intense if the bonds were offered for tender to two or more strong syndicates of dealers who could sound out the market in an organized way ahead of time and would not have to worry about irrational bidding from smaller dealers and brokers. Towards the end of 1962, the United States Treasury successfully marketed a $250 million long-term bond issue in this way, but despite its small size in relation to that market a later issue failed to attract buyers and the syndicate was left with a large unsold position.[13] The Canadian industry is not yet large enough to handle Government of Canada issues by auction to competing syndicates, even allowing for the fact that the Bank of Canada and the government accounts would presumably take substantial amounts of the issue at the average tender price. In any event, we see no need to experiment with such a system at the moment, although we certainly would not wish to rule out its use at a later date.

We also received suggestions from some I.D.A. members that the federal government negotiate underwritings with a single syndicate. This ignores the fact that the Bank of Canada is the fiscal agent for the federal government and that basic debt management policy must be tied in with other government policies. The government would have to set the terms and amount of the issue if it were not to conflict unnecessarily with monetary policies, while the Bank would have to continue to operate in the securities markets for policy reasons; we fail to see, therefore, the

[13] The United States Treasury normally markets bonds directly and the banks and dealers receive no commission on orders handled by them.

desirability or feasibility of establishing a single underwriting syndicate. It would surely raise the costs of distribution and place the Bank in a position in which, instead of being able to tap the experience and judgment of a number of individual dealers, it would have to negotiate with a monolithic organization interested primarily in its own profit margins. Given the rigidity of other underwriting syndicates, existence of a single group of private underwriters would doubtless lead also to difficulties and discrimination in the composition of its membership.

The final way in which the present system of distribution of new Canada issues could be altered is to adopt a "tap system" under which the central bank and/or government accounts purchase the issue, or a significant part of it, from the Treasury and distribute it over a period of time as the market demands it. In the United Kingdom, securities not subscribed for by the public are taken up by the Issue Department of the Bank of England and are marketed through the Government Broker over the following weeks and months at a price which is usually a little below the current price of comparable government issues. The few issues on tap are closely watched by the financial community and regarded as the bellwethers of the gilt-edged market. The main advantage is that it avoids the lumpiness of the existing technique with its pricing and distribution problems. On the other hand, the market will be thin and the issue will lack liquidity if a substantial proportion is not distributed initially, while dealers will be reluctant to carry inventories and make markets if the authorities in fact completely dominate the issue. Clearly, this technique makes no contribution to the development of self-reliant and resilient markets. There may be times when the monetary authorities wish to supply bonds to the public in substantial amounts or to establish precise levels of rates on certain securities, but this can be done without changing the method of distributing new issues.

In recent years, the Bank of Canada has occasionally taken the whole and frequently taken a part of a new issue but its intentions about resale have not always been clear. Dealers have thus not known whether the bonds would be offered to the market, and if so on what terms, until the Bank subsequently indicated a willingness to accept bids. Since some of these Bank offerings were subsequently withdrawn in a few days, this method of operating cannot be considered a true tap system. It does, however, have merit as a method of curbing excessive speculation in new issues. When such securities are acquired by the Bank and government accounts in exchange for shorter-term bonds and with the intention of subsequently distributing them in the market, moreover, this technique can make a useful contribution to refunding the publicly-held debt in advance of maturity.

The present system of nation-wide distribution of new federal issues by a large network of primary distributors selected by the Bank works effectively on the whole. Pricing problems have not proved too serious in the recent past, and improved contacts and communications with the investment community should minimize them in the future. However, the number of primary distributors seems unnecessarily large, and allotments do not always appear to reflect their true placing power. There is evidence that some of the dealers involved, including some who are primarily brokers, make virtually no contribution, merely selling their allotments directly or indirectly to the larger dealers and banks. While we recognize that there are geographical and other considerations which prevent the Bank from adjusting participations as rapidly as it might desire, we believe that the industry would be healthier, and distribution more effective, if such weak firms were eliminated from the list and their bonds reallotted to the growing houses. While over 85% of commissions on new federal issues are paid to banks and the 32 investment firms which carry large positions in government bonds, we would not want to see the group automatically closed to smaller and growing members of the industry as long as their placing power makes a significant or increasing contribution.

We also considered a number of other changes in marketing techniques in our search for ways to improve the market for Canada bonds, including the possibility that the government go to market at fixed or known intervals or give more advance warning of a new issue. The former might facilitate the scheduling of new issues by other borrowers, and both would give potential investors more time to review their portfolios. However, they would reduce the flexibility of the debt managers and probably also lead to stagnation of the markets while dealers and investors awaited the terms of the new issue. While commending the practice of giving the market a few days notice of a new issue and while urging that the government keep the market informed of its probable cash needs we do not believe that regular issues or extended notice would on balance be an improvement.

The Canada market might, however, benefit significantly from a reduction in the number of issues outstanding and an increase in their size. Although fewer and larger borrowings at one time might cause major digestive problems for the market, we see no reason why new borrowings should not add whenever possible to outstanding issues, gradually building them up to a size that will make for more active secondary markets and a higher degree of liquidity while simultaneously eliminating smaller issues for which no real market exists. It would not be possible, of course, to add to issues selling at deep discounts, especially in view of the action taken in December 1960 to stem the practice then springing up among junior governments of offering low-coupon, deep-discount bonds to maximize the tax-free return to investors and reduce their own borrowing costs. The withholding tax also makes it technically awkward to add to issues released prior to that time which are exempt from withholding tax.

Finally, we wish to express our agreement with the Bank of Canada about the unsettling effects on the market of the practice of "riding" new issues. If a new issue is rising in price, a rider places an order to buy with the intention of selling before the delivery date, thus taking a profit without having to put up any capital. This inflated but short-lived demand may cause an unrealistic price increase followed by a rapid price drop to the disillusionment of true investors. A second abuse, "withholding", occurs when a dealer withholds a new issue from his customers in a rising market and subsequently takes the capital gain for himself. Both these practices have harmful effects on markets and on the reputation of the securities industry. As the Bank of Canada reminded us, "orderly marketing of an offering of new bonds is important not only for the particular issue concerned but also for the reception which will be accorded future issues. Primary distributors and investors who have been involved in unfortunate developments with one issue are apt to demand greater price concessions on, and may take a more speculative view of, the next issue".[14] The National Association of Securities Dealers in the United States specifically makes free riding and withholding violations of their Rules of Fair Practice, but nothing is said about them in the by-laws and regulations of the Investment Dealers' Association. In our view, the Canadian industry should take a stronger stand on these two matters. Some of the riders are institutional traders well-known to dealers who could be stopped if dealers acted in concert and with the cooperation of the senior management of the financial institutions. Apart from self-regulation, riding would be diminished were the subscriber required to put up a cash deposit upon placing his order or, in the case of refunding, to deposit some proportion of his holdings of the maturing issue.

We will be dealing in a later chapter with the question of Canada Savings Bonds and the issues they raise, but we might note that the dealers play an active role in their distribution along with banks and trust companies, caisses populaires, Quebec savings banks and the provincial savings offices. The growing proportion of the federal debt represented by these bonds is one of the factors leading to the relative shrinkage of the retail market for other securities and has thus contributed to the increased orientation of the

[14] Submission IV, paragraph 34.

industry towards institutional and more skilled investors noted earlier. Despite this trend, however, the absolute size of the industry's placing power continues to grow, and it has shown itself capable of handling government issues running into many hundred millions of dollars. While money market issues may be sold to not much over a thousand customers, the industry has obtained as many as 20,000 orders for a single issue designed for the retail market.

The bond and money markets and the dealer industry which is at the heart of them have all grown, diversified and matured in the post-war period. These expanded activities have resulted in increased placing power and broader trading markets and have played an important role in financing the country's development. The industry, with some exceptions, has become more professional, competitive and enterprising while standards of business conduct have been significantly raised. True secondary markets have been developed where none existed before, and this has made it relatively easier and cheaper to raise capital and has provided the central bank with an improved vehicle for its own operations. The Bank of Canada has encouraged much of this market evolution—both publicly and privately—and, although its relations with the industry are less good than they should be, must share much of the credit for these developments. The industry performs its function at reasonable cost, with the notable exception of some underwriting activities on which margins seem to us unduly high for the true liability assumed and the few losses actually incurred. The issuers, however, must share the blame for this lack of competition as there often are other houses willing to undertake the business at more competitive rates. One other area of weakness is the reluctance on the part of the bigger established firms to underwrite smaller or less seasoned enterprises, a factor which may contribute to the higher costs of these issuers in other sectors of the industry. With these exceptions, the industry has performed its job of raising and allocating capital with vigour, imagination, and efficiency.

CHAPTER 17

THE STOCK MARKETS AND SECURITIES LEGISLATION

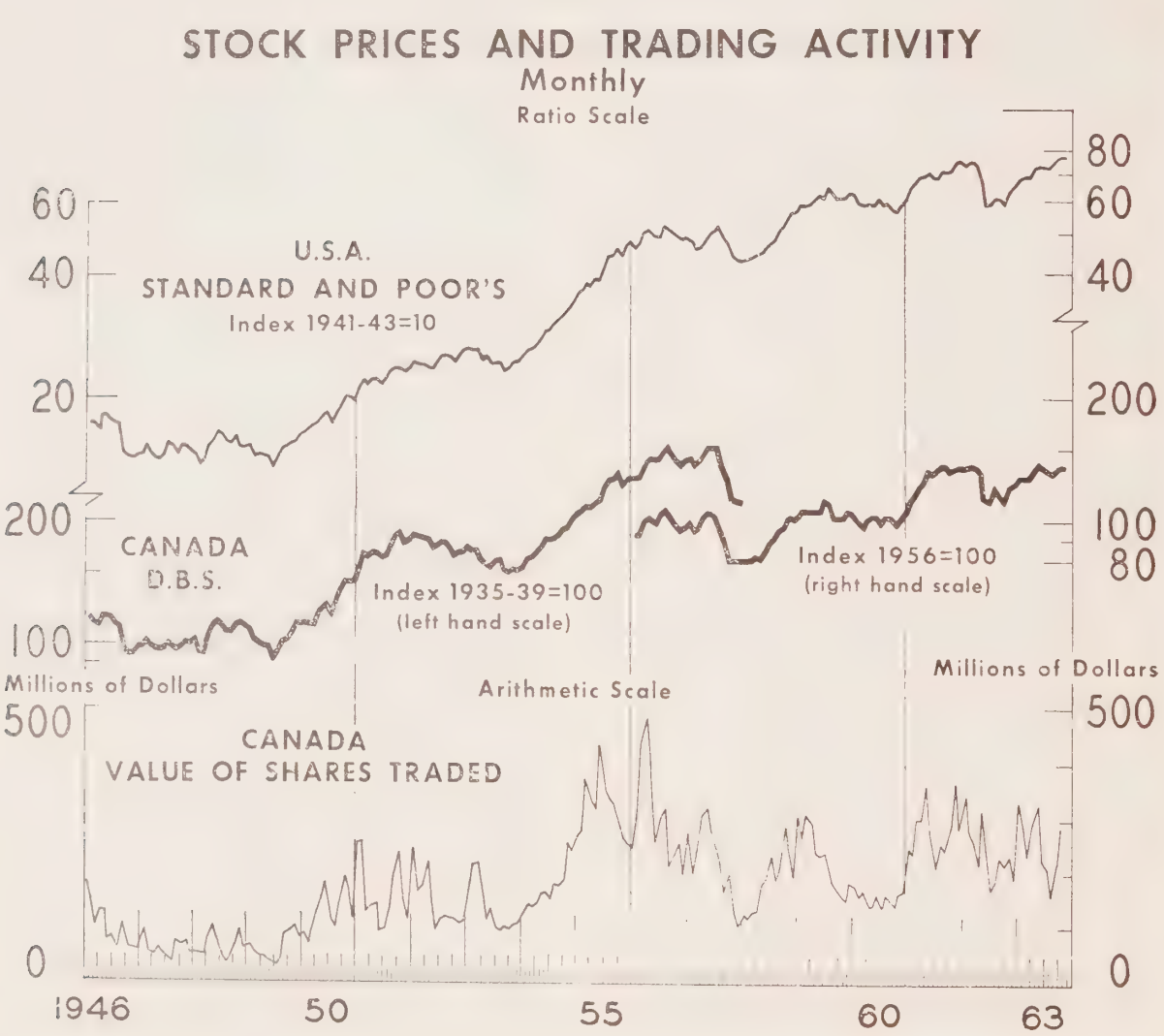
The organized stock exchanges and the over-the-counter markets in preferred and common shares perform much the same functions for equity securities as the bond and money markets do for debt obligations. They serve as convenient trading centres, as guides to values and as mechanisms for enhancing the liquidity of shares. They are not, however, so intimately influenced by changing credit conditions, although affected by them, since equity prices are influenced mainly by current and prospective profit levels and by investor confidence. The stock brokers also differ from the investment dealers in that they act almost entirely as agents in the execution of orders, serve only rarely as principals, and carry very small inventories. Moreover, most new issues of industrial and major mining and oil companies are handled by investment dealers despite the increasing activity of stock brokers in underwriting. A third category of dealer, the broker-dealers, are however engaged principally in the business of distributing speculative issues to the public, often through the facilities of a stock exchange but also in the over-the-counter markets. Since it is in connection with these equity markets that the main issues of securities legislation and the protection of the investing public arise, they are dealt with in this chapter even though some of the discussion relates to the bond market as well.

Although the average level of skills required in the stock market industry is somewhat lower than that of the average I.D.A. member, partly because of the agency nature of the business and partly because uninformed investment still seems as rewarding to some investors as a more intelligent approach, the same basic forces are leading to the evolution of a more competitive and professional industry. The growing role of institutional stock market buying can be seen from the expanded equity holdings of mutual, pension, and trust funds cited in earlier chapters. It appears that purchases by these and other institutionally managed accounts have been equivalent to at least 60% of net new stock issues in recent years. While the institutional percentage of market trading is nothing like as high, these buyers do constitute an increasingly important share of the business. They, and other clients, now expect more expert security analysis and advice, a factor which has created a demand for university-trained people and has led to the gradual abolition of over-long and under-paid routine apprenticeships which failed to attract top-calibre personnel. As with investment dealers, these large buyers have demanded, and received, price concessions on large orders and this too has contributed to the search for more efficiency and more competent management in stock firms.

Moreover, the ending of rapid economic growth, which had been accompanied by high demands for funds, rising profits and commodity prices, and over-exuberant estimates of future prospects, has had its effects on the industry. Stock market activity has subsided considerably from its levels in the mid-50's when markets were rising from the under-valued levels of 1949,

and this has significantly affected the revenues, profitability, and business volume of the stock brokers. Business has thus become more competitive and the penalties of inefficiency more severe. The combined value of trading on the Toronto and Montreal exchanges and the performance of the D.B.S. industrial stock price index (Chart 17-1) show these trends. It will be noted that trends in Canada closely parallel those in the New York market, owing as much to the similar pattern of economic activity and business sentiment in the countries as to the close links between the markets themselves. Stock market prices and volume naturally will continue to fluctuate with business activity, investor sentiment, corporate profit trends, and the level of yields on alternative investments. They will probably also continue to lead business cycle turning points since they are a sensitive barometer of consumer and business confidence. Nevertheless, the average level of activity may well remain at lower levels, and this, combined with the growing demands of

Chart 17-1



more sophisticated investors, will confront the industry with more exacting competitive conditions.

There are about 200 brokers and broker-dealers in Canada, most of whom belong to at least one stock exchange. The largest exchanges are Toronto, with 98 members, and the Montreal and Canadian exchanges with a combined membership of 103; the Vancouver and Winnipeg stock exchanges have some 45 and 30 members respectively. There are in addition 66 members of the Broker-Dealers' Association of Ontario, some of whom are members of the Toronto Stock Exchange. About three-quarters of the members of the main exchanges belong to the I.D.A. or are closely affiliated to I.D.A. members. Both in number of firms and in capitalization the Canadian industry is about one-fifteenth that of the United States, approximately the same relationship as that between the gross national products of the two countries. The number of stock-broking firms has tended to be fairly stable in recent years, but broker-dealer membership has fallen precipitously from 179 firms at the peak of the resource boom of 1950-51 to 66 firms in March 1963.

Even more than the investment dealers, the brokers are highly concentrated in Toronto and Montreal, although one-quarter of the T.S.E. firms have branches elsewhere in Ontario and 10% have wider branch networks. A few of these branch systems are quite extensive and there is a tendency for firms to become more national in scope; this has, if anything, led to more business for the Toronto and two Montreal exchanges which account for 97% of the value of stock exchange trading in Canada. However, there is less concentration of business than in the dealer industry; for example 17% of the reporting membership in Toronto earned about 38% of the commissions while about the same proportion of firms in a Montreal survey earned 50%. It will be recalled that less than half this proportion of I.D.A. members had about half of the income and capital of that industry. The type of firm in the brokerage business also varies enormously, from small two-man operations of an unskilled and personal nature, or perhaps trading only for their own account, to very large firms, some of them quite highly specialized and some with very high standards of competence. There are also firms of all sizes which specialize in the underwriting and distribution of speculative mining and oil company shares.

Brokerage commissions accounted in 1961 for almost 80% of the total revenue of Toronto Stock Exchange members and 77% of the total revenue of members of the Montreal exchanges. Trading and underwriting income, mainly the latter, made up 13% of revenues, almost twice the proportion in 1951. This represents an attempt to diversify, encouraged by sharp fluctuations in net income which in the five years reported in the special T.S.E. survey fluctuated from 1.3% of capital and surplus to 19.8%, averaging the reasonable figure of 8.5%. These figures may, if anything, exaggerate true profitability since salaries and bonuses to partners and shareholders are under 10% of revenue and have shown no pronounced tendency to rise.

The stock exchanges establish the minimum amounts of capital required by member firms and relate them to the volume of business transacted, usually insisting that this capital be additional to that invested in exchange seats, fixed assets, and office equipment. The balance sheets of Toronto member firms showed that they had assets of $138 million, mainly arising out of routine customer receivables and margin accounts; inventories of shares were under $4 million. The main sources of financing, apart from client credit balances, were call and other loans, mainly from the banks, and their own capital, which stood at over $31 million. As the following table shows, the combined capital of Toronto and Montreal members has doubled in the past decade despite the decline in earnings rates in the interval.

The capital requirements of the stock exchanges seem to protect the public adequately, although the minimum standards of the Broker-Dealers' Association appear to be unduly low, calling only for a minimum of $5,000 of free capital; in our view, this should be raised and related to business liabilities. Regular and surprise audits are made

CAPITAL AND INCOME

	1951	1959	1960	1961
		($ millions)		
Toronto stock exchange	14.0	32.8	30.2	31.2
Montreal and Canadian stock exchanges	9.6	16.1	14.9	16.0
TOTAL	23.6	48.9	45.1	47.2
Net income as % of capital (T.S.E. reporting members only)	19.8%	11.4%	1.3%	7.9%

For additional data, see Submissions of the Exchanges.

to ensure that the standards are being maintained and the stock exchanges have their own examiners to ensure that this task is properly carried out, a matter of particular importance since the provincial securities administrations are for the most part satisfied to leave these functions to them. The stock exchanges also require minimum insurance coverage against risks which could involve loss to the public and relate this to the size of the business transacted. However, the B.D.A., which requires a broker's blanket bond or securities insurance in a minimum amount of only $10,000 for members in five major cities and of only $2,000 elsewhere, ought in our view to relate the minimum more closely to the size and nature of the risks. Our comments in the previous chapter dealing with publication of regular industry financial statistics, the net worths of individual firms, and full disclosure of each firm's financial position to depositors and those holding credit balances, apply with equal force to brokers and broker-dealers.

The stock exchanges have among their aims the protection of the public, and do encourage sound financial practice and high ethical standards. Despite the progress that has been made, however, these bodies lack the funds and authority to do the whole job themselves, occasionally find themselves in conflict with their members, and quite frequently encounter massive indifference from a public anxious to make a quick profit on speculative securities.[1] Unfortunately, moreover, the securities administrators are often all too willing to pass the difficult regulatory problems on to the self-regulating associations. The stock exchanges are public corporations incorporated under provincial legislation and supervised by provincial securities commissions, but their powers of disciplining and controlling members are not always clear: where they are, there is frequently no appeal to an outside agency. In general, the exchanges control the admission of new members, set the terms for continuing membership, determine trading, margin[2] and delivery regulations, and establish the conditions to be met by companies whose shares are listed for trading. In addition to these self-regulatory functions, they carry on investor education programs through publications and advertising (this activity being restricted by limited budgets), provide a comprehensive quotation service, and represent the industry in discussions with public bodies and others.

The Broker-Dealers Association of Ontario was created by a public act of the Ontario legislature in 1947 to provide for a measure of self-government and internal self-regulation among that segment of the securities industry principally engaged in raising speculative capital for natural resources exploration and development. The conditions existing in resource financing prior to this period have been described as "something in the nature of a jungle."[3] While the Association also represents its members more generally, its primary function is the enforcement of financial and ethical standards in the industry. Here again substantial improvements have been made, although the present situation is still something less than perfect.

THE STOCK EXCHANGES

The primary function of the stock exchanges is to provide a well-known centre where close and

[1] See, for example, evidence of Vancouver Stock Exchange, Transcript pp. 70-75.

[2] The amount that a customer may borrow against the collateral of securities.

[3] Testimony of Hon. C. P. McTague, former Chairman of the Ontario Securities Commission before a Select Committee of the Legislature in 1951; cited in B.D.A. Submission, paragraph 1.

continuing markets are made and equity securities trade freely in response to basic investor preferences. By increasing public awareness of share prices, reducing the costs of investing, and increasing the marketability of equities, stock exchanges can make a valuable contribution to the broader ownership of listed shares. These wider holdings, and the resulting reduction in yields, also enhance the ability of issuers to raise funds through equities. However, as we will point out later, there are certain features of stock exchange operations in Canada which may operate to increase investor costs and impair the free workings of the markets: to the extent that they engender investor distrust of common stocks, these factors inhibit the growth of Canadian share ownership.

The range of equities available to the Canadian public is somewhat narrower than that in the United States because of the different pattern of our industrial development—for example, there are no Canadian companies engaged in the production of certain types of chemicals, electronics, and specialized industrial components. It is also limited by the extent of foreign ownership, by the smaller size of many Canadian companies which makes them less suitable for widespread investor participation, by the extension of government ownership over relatively large segments of the utility industry, and by the mutualization of insurance companies. On the other hand, shares in natural resource companies have more prominence in Canada, and "penny" mining shares abound on both the stock exchange and the informal "over-the-counter" market. We have already noted that Canadian corporations have taxation reasons for raising new funds by debt issues whenever possible, but this factor tends to limit the supply of common stocks with equal force in the United States.

However, more of the equities available for public investment are listed on stock exchanges in Canada. In the United States, the number of unlisted issues quoted in daily newspapers is some three times the 1,600 stocks listed on the New York Stock Exchanges, while in Canada—excluding the penny mining shares—the proportions are about reversed. This is partly because of the lower listing standards of Canadian exchanges but partly also because of the fact that American supervision of unlisted stocks has been relatively less stringent than that applying to listed shares. In Canada, the difference between the two standards of supervision—while real—is less marked, and companies in this country have thus not had the same incentive not to list their shares.

As we noted in Chapter 2, a relatively small proportion of the population owns common stocks in both Canada and the United States. In both countries the proportion of shareowners is rising, although the rate of increase seems faster in the United States. As might be expected in view of the costs and difficulties of managing small holdings of common stocks and of the desirability of acquiring other more liquid assets first, some 63% of aggregate dividend payments to Canadian individuals filing taxation statements for 1960 were made to those with incomes of $10,000 and over and 35% to those with incomes of $25,000 and more, even though these groups represented only 3.2% and 0.4% of the number of taxpayers respectively.

In the United States, a similar high concentration of stock ownership exists, although in that country the under $10,000 income group accounted for 64% of the number of shareowners compared to 56% in Canada. There is nevertheless a striking contrast between the attitudes of shareowners in the two countries: whereas 62% of the American holders surveyed in 1961 (and 51% of those surveyed in 1963) had bought shares for long-run investment, only 35% of the individuals (excluding members of the Exchanges themselves) who bought stock during a three-day survey conducted by the Montreal exchanges in June 1962 did so with the intention of holding the stock for longer than six months.[4] While un-

[4] Submission of Montreal Stock Exchange and Eleventh and Twelfth Public Transaction Studies of the New York Stock Exchange—September 13, 1961 and October 16, 1963. The New York results may be somewhat biased by the more stringent taxation of short-term trading profits in the United States and the relatively favourable treatment of profits on stocks held more than six months; the latter are subject to a reduced capital gains tax rather than ordinary income taxes.

due reliance should not be placed on one Canadian survey taken in a time of falling markets, this evidence does seem to suggest that a high percentage of Canadians regard equity ownership as a short-term speculation rather than a longer-term investment.

We have no evidence of the extent to which stock ownership in Canada is affected by the 20% tax credit on dividends from Canadian corporations and the absence of a capital gains tax, and a review of these arrangements in any case falls within the terms of reference of the Taxation Commission. However, we believe it important to encourage individual Canadian ownership by providing more information to investors, reducing the cost of modest share purchases and tightening up securities legislation. As to institutional buyers, who accounted for about 20% of purchases in the Montreal survey already referred to, we noted in Chapter 13 that relatively small amounts of equities were held by life insurance companies and made suggestions which we hope will encourage them to expand their holdings. Pension funds and the estate, trust and agency accounts of trust companies are already substantial and increasing buyers of common shares, while banks and other deposit-taking institutions cannot ordinarily be expected to be.

Although it is difficult to make comparisons of United States and Canadian dividend yields on companies with similar prospects and risks, such yields in Canada appear to be lower than in the United States and do not support the view that there is a lack of buyers in the Canadian market.[5] Rather, these yield data suggest that there may be some shortage of Canadian equities available for public ownership, a conclusion which is reinforced by the quite high proportion of all equity holdings in the estate and personal trust accounts of trust companies, 6% and over 20% respectively, which is invested in foreign equities. Moreover, as members of the Montreal Stock Exchange told us, a number of American brokerage firms have found it profitable to establish in Canada to meet the demand of our investors for American issues, particularly of the variety not found in Canada. These firms had about 25% of the commission business of reporting members of the Montreal and Canadian Stock Exchanges in 1961. This and other evidence suggests that if wider Canadian ownership of equities is to be achieved, measures must be taken at the same time to encourage non-resident owned Canadian firms to make their shares available to the public in Canada. While it is not within our competence to suggest any concrete taxation measures which might be taken to foster such a development in sound ways, we welcome the attempts of the stock exchanges to promote the issuance of shares in such companies to the public. We also strongly urge that those firms whose earnings records and size justify this course should do so wherever possible.[6]

There are a number of ways in which the stock exchanges themselves could help to encourage more widespread ownership of listed stock. First, some amendment might be made to the commission structure to make it more logical than the present one, which has evolved in a somewhat haphazard way. The Toronto Stock Exchange submitted evidence that rates per share on its exchange are substantially lower than those in New York for shares selling below $5.00—in which trading volume is greater than in New York —somewhat higher in the $5.00-$30.00 range, very slightly lower for shares between $30.00 and $80.00, and considerably higher for shares selling above $150.00.[7] The Toronto Stock Exchange has recently allowed the commission scale to be reduced to one and one-half instead of two commissions on a buying and selling transaction of over $100,000 and to one full commission on transactions of over $250,000. These concessional rates were devised as part of an attempt to discourage the large amount of block trading being done off the exchange.

Without wishing or feeling qualified to make detailed recommendations, we believe there would be merit in simplifying the commission structure, in

[5] The more generous dividend credit for tax purposes in Canada affects these yield comparisons.

[6] See also the discussion of this subject in Chapter 5.

[7] Submission, paragraph 55, and Appendix 35.

keeping commissions at a low level, and in providing a greater reduction in the commission costs of large transactions. These advantages might be obtained by commission rates which were a low fixed percentage of the value of a transaction and which provided for a discount on transactions above a certain value. Such a system would also facilitate stock splits designed to encourage wider equity ownership. At present, if a company splits its shares, it almost invariably increases commission costs for the buyer or seller of a given dollar amount of stock, as shown by Table 17-1. This irrational cost increase, which acts as a deterrent to splits designed to attract those with small amounts to invest, would be eliminated by an appropriately revised commission structure.

We received a suggestion that bond-holding by investors would also be encouraged if these securities were listed on stock exchanges. Some bonds are listed on the New York exchange but trading is insignificant in relation to that in the over-the-counter market. In fact, bond-trading is not well-suited to a market where client orders must be exactly matched, in addition to which the commission structure would inevitably be higher and the present highly efficient bond-trading arrangements might well be disrupted.

The exchanges should, however, raise their listing standards for shares. No distribution of share ownership other than that of "adequate public distribution", is officially required in Canada, and even this has been fairly liberally interpreted. By contrast, the New York Stock Exchange believes that close, continuing and broad markets will only be attained if companies applying for listing have a public holding of at least 500,000 shares, exclusive of concentrated or family holdings, distributed among at least 1,500 shareholders; a relatively low weight is given in these calculations to holders of fewer than 100 shares. Moreover, a minimum trading volume of 100,000 shares a year is expected. While these standards would be too high even for the biggest of our exchanges—only a minority of industrial issues listed in Toronto traded more than 100,000 shares in 1962—some increase in distribution requirements would be desirable. These standards have been so low as to permit stocks to be listed with as few as 8% of the shareholders controlling over 93% of the common shares outstanding and to retain listings of some issues which trade fewer than 500 shares in a year. The resulting wide spreads reduce the liquidity of shares and make their markets susceptible to easy manipulation. While the exchanges are conscious of this problem and have raised their requirements somewhat, it would be helpful if they were to raise them further to ensure that there is an adequate auction market,

TABLE 17–1

BROKERS' COMMISSIONS BEFORE AND AFTER STOCK SPLITS

Pre-Split Price per Share	Pre-Split Commission	Pre-Split Commission	Shares Split 2 for 1		Shares Split 4 for 1		Shares Split 8 for 1	
			Commission	Commission	Commission	Commission	Commission	Commission
	$	%	$	%	$	%	$	%
$110.00–119.99	60.00	0.55	80.00	0.73	140.00	1.27	200.00	1.82
100.00–104.99	55.00	0.55	80.00	0.80	140.00	1.40	200.00	2.00
75.00– 75.99	45.00	0.60	70.00	0.93	120.00	1.60	160.00	2.13
50.00– 52.49	40.00	0.80	70.00	1.40	100.00	2.00	120.00	2.40
35.00– 35.99	35.00	1.00	60.00	1.71	80.00	2.29	80.00	2.29
25.00– 26.99	35.00	1.40	50.00	2.00	60.00	2.40	56.00	2.24
20.00– 20.99	30.00	1.50	50.00	2.50	60.00	3.00	36.00	1.80

NOTE: The pre-split commission is based on 100 shares. The commission after the stock split is based on a sale of shares with the same total value as the pre-split block. The price used in calculating the percentages is the lowest price per share in each category.

SOURCE: David F. Wright: *Stock Splits from the Company Viewpoint.* Unpublished paper for the University of Toronto School of Business.

even if this involves losing some listings. Typical spreads between the bid and offering prices of more actively traded industrial stocks of reasonable quality are as little as one-eighth of a dollar (for some reason the exchanges have not adopted the more convenient decimal system).[8] Buyers and sellers can thus be brought together with a minimum concession on one side or the other, a condition which does not apply on less broadly-held issues where the spreads between buyer's bid and seller's offer may range up to several dollars and represent a significant percentage of the amounts involved.

Other aspects of listing requirements which could stand improvement are those related to the size and earnings of listed companies, standards of disclosure, and the de-listing policy of the exchanges. In New York, for example, listed companies are required to demonstate net profits of $1 million annually under competitive conditions and should have net tangible assets of at least $10 million. Toronto has no set standards for industrial listings but considers them on the basis of earnings records, "proof of consistent earnings being regarded as removing the security from the highly speculative field".[9] Moreover, the absence of consistent earnings does not necessarily disqualify a company for listing if it can show net tangible assets of $1 million, working capital of $250,000 and a "projection of earnings satisfactory to the Listing Committee".[10] Present listing policy on exploratory mining companies is of course somewhat different. They may be listed if sufficient exploratory work has been carried out to enable them to provide a competent engineer's report and if they have cash on hand or a "plan to raise sufficient funds to carry out the recommendation".[11] Oil and natural gas companies may be listed on the basis of adequate financing and a cash flow sufficient to ensure the continued life of the company—i.e. about $25,000 to $50,000 annually.[12] While these standards have been imposed over the years, they are still so low that they involve the listing of many speculative issues and lead some investors to believe that all listed common shares are speculative in nature. In some cases this discourages equity investment, a difficulty that would be avoided by significantly raising listing standards on the main exchanges and transferring other issues to either a subsidiary exchange or the over-the-counter market.

Moreover, while the New York exchange requires high annual disclosure standards, regular periodic reporting, solicitation of proxies, and publication of all transactions by "insiders"—officers and controlling shareholders—no such requirements exist in Canada. The Canadian exchanges do, however, insist on certain minimum disclosure standards to be described later, although they are comparatively reluctant to de-list dormant companies and those that fail in other ways to maintain original listing standards. We were told that de-listings for reasons other than voluntary choice or outright fraud were very infrequent, not amounting to half a dozen in recent years. The Toronto exchange, which has long been conscious of the problem, has recently adopted a more stringent de-listing policy. However, because of the undesirable competition for listings between the Montreal and Toronto exchanges, which goes well beyond the point of a normal healthy rivalry in some instances, it may prove difficult to pursue this desirable program with sufficient vigour. It is also claimed that de-listing for failure to meet exchange standards would further hurt the shareholders concerned, although we feel that on balance a lax de-listing policy can only harm the interests of both the shareholders concerned and the broader investing public. A final reason for these difficulties is that, unlike the situation in the United States, there is no sanction from securities or companies legislation to support the exchanges in such efforts as they have made in this direction. For example, the Toronto Stock Exchange a few years ago approached almost 400 listed companies urging them to publish interim reports; just over 50 agreed to do so and the majority

[8] Very low-priced stocks trade in steps of ½ a cent, while stocks under $5 trade in 5¢ steps.

[9] Submission, paragraph 216.

[10] *Ibid.*

[11] *Ibid,* para. 217.

[12] *Ibid,* para. 218.

did not even bother to answer. While Canadian listing requirements could not as a practical matter be as high as those in New York, we will make recommendations designed to raise both listing and disclosure standards later in this chapter.

The stock exchanges have a heavy responsibility to ensure that the ethics, trading practices, and standards of qualification of brokers dealing through the exchanges are adequate. Significant progress has been made in many directions but qualifications for salesmen are still minimal compared to those in New York. Moreover, the minimum requirements for membership in an exchange are extremely low: in Toronto, for example, they are that a candidate be a British subject of twenty-one with three months experience in the industry and that he be able to meet the minimum capital requirements mentioned earlier. In addition, a seat must be available for purchase by him, he must be acceptable to the Governors of the Exchange, and his application must be approved by 80% of the members voting (in Montreal the figure is now 66⅔%). While the members exercise considerable discretion in admitting new applicants, we believe that the basic standards ought to be raised substantially and that rejected applicants should have the right of appeal to the relevant securities commission in order to ensure that the exchange's decisions have not been biased or prejudiced. This would still enable the industry to make judgments based on its intimate knowledge of the applicants but would guard against the abuses inherent in unsupervised self-government.

It will probably also be necessary for the main exchanges to enlarge their membership as the demand for their services expands, a factor which they are no doubt taking into account in making plans to move into new quarters. Certainly the national exchanges in New York and London have a very much larger membership than those in Toronto or Montreal; London has about 3,500 members and almost 500 member firms while New York has 1,366 members and 681 member firms compared to the approximately 100 members of Toronto and Montreal. Study might be given to the merit of altering the method of obtaining membership only by purchase of an existing seat if this can be done in ways which protect members who have invested sizable sums in such assets.[13] The rules of both the Toronto and Montreal exchanges also provide that in the case of the failure of a member the seat may be forfeited and sold by the exchange for the benefit of the creditors, including other member firms, the exchange, and the public, with any balance being returned to the defaulting firm. The exchanges take pride that, partly as a result of this system, the public has never suffered as a result of the failure of a member firm. This advantage could however, be retained by requiring new members to pay a fixed entrance fee related to the present value of memberships. Members would be entitled to a refund on resignation, and a supplementary fund could be built up out of the exchanges' earnings to meet withdrawals in excess of new memberships. By removing the fixed limit on membership and tightening up on basic membership requirements, public confidence in the exchanges would be strengthened, the financial soundness and experience of member firms would be improved, and competitive forces would be allowed more play.

A number of other steps might be taken to improve public confidence in the exchanges. First, the exchanges should continue to expand the size, skills, and responsibilities of their full-time staff. This trend, already well under way, has not yet gone as far as in New York, particularly on matters relating to listing and de-listing of shares, the policing of floor transactions, and disciplining members for infractions. The Boards must have the final verdict, but by giving increased powers to permanent officials with intimate knowledge of the business many of the advantages of self-discipline can be retained. At the same time, a number of its disadvantages—particularly the tendency to be unduly lenient in some instances and unduly harsh in others—can be reduced or eliminated. Second, the governing boards of the exchanges—now elected from the membership—

[13] Seats in Toronto sold for as much as $130,000 and $140,000 in 1955 and 1959.

might be supplemented by the appointment of a minority of public governors from outside the industry. This has worked well on the New York Stock Exchange where good public governors have been recruited and given real responsibilities. Both major exchanges have moved in this direction by appointing full-time presidents from outside the industry, but there is still a good case for drawing on the experience of participants from other industries who can bring fresh perspectives to the exchanges' functions and problems.

The exchanges should also reinforce the commendable efforts they have made to prevent trading abuses and the manipulation of markets. Both the main exchanges have rules which provide that client orders must be given priority over those of member firms and professional traders, although of course they are difficult to police.[14] The right of the customer to such priority is incontestable, and although professional traders can promote greater price continuity and minimize market fluctuations by being willing to take risks and speculate, they can in certain circumstances also aggravate price swings. Very little is known about the effects of such trading in Canada, although studies in New York indicate that the overwhelming majority of trading by specialists with particular responsibilities is stabilizing in nature. This, however, is apparently not true of activity by floor traders.[15] The Montreal survey in 1962 showed that almost 30% of transactions were by members for their own account, while an earlier Toronto survey showed a more modest proportion, 10-12%. While the recent S.E.C. study recommended prohibition of professional trading by floor members, we have not carried out the detailed examination of Canadian trading necessary to make recommendations at this time. In view of its importance in total trading, however, we believe that member trading should be closely supervised, both by the exchanges and securities administrators, and that strong action should be taken if evidence of abuse is uncovered.

The Toronto Stock Exchange has twice experimented with the use of specialists on the trading floor. These experiments were limited to three specialists with about 30 stocks and were carried out over approximately a three-month period. In the first experiment, the specialists were given the same powers as those on the New York and American Stock Exchanges; that is, they traded for their own account, maintained a "book" in which they listed all "limit orders"—orders to buy or sell at specific prices given them by other brokers—and handled "odd-lot" orders.[16] The results of the experiment suggested that the market was not significantly improved by these operations and that many members resented the substantial advantage the specialist had trading in the securities for which he kept the book. In the second experiment, officials of the Exchange were used. They undertook only two functions: to keep a book on limit orders and to deal in odd lots. Somewhat more enthusiasm was engendered for this system but the members were reluctant to provide funds with which the specialists could operate and undertake the risks involved. The latter system might be more efficient than the present one because fewer floor traders would be needed to fill limit orders, especially in rapidly changing markets. It might also improve the market in odd-lots and reduce the costs of these transactions, although some floor traders now do in fact specialize in this field. In any event, the price at which odd-lot sales can take place should be regulated, as it is on the New York Stock Exchange. This would protect and encourage the small investor in higher-grade securities.

Much more serious possibilities of abuse arise from the unique practice of some Canadian exchanges of permitting the primary distribution of shares through their facilities. In the course of such a distribution, which normally involves the sale of treasury shares but may also entail dis-

[14] This is particularly true of undisclosed short sales by floor traders, which we understand is a problem on some exchanges.

[15] S.E.C. *Special Study of Securities Markets,* Washington 1963. This study was prepared by the S.E.C. staff and does not necessarily carry the approval of the S.E.C. itself.

[16] Odd-lots are blocks of fewer than 100 shares for most industrial securities selling below $25 a share, fewer than 25 shares of securities selling between $25 and $100, and fewer than 10 shares if the stock sells at $100 or more.

tribution of existing shares by the controlling interests, a true auction market no longer exists. The offering price is not established by the independent judgment of numerous individual shareholders but by the offering price of the underwriter or his agents. Moreover, unrealistic bid prices may also be maintained by these same interests in the hope of attracting public buyers anxious to make a profit on a rising and active market which by one means or another they are led to believe may be going higher still. The arguments in favour of allowing such distribution to take place through the exchanges are that there would otherwise be a primary over-the-counter market existing side by side with the exchange's true secondary market and that this would result in two relatively thin and more easily manipulated markets. Moreover, it is argued that it is easier to regulate malpractices on the exchanges than in the unlisted market. For these reasons the exchanges require the entire authorized capital of mining, oil, and other speculative issues to be listed, whether issued or not, so that any additional shares can only be issued under the supervision of the exchanges. This rule does not apply to seasoned issues where the exchanges will only list the issued shares.

The broker-dealers are usually involved in such speculative underwritings, whether or not carried out through the exchanges. Although underwriting for the exploration and preliminary development of mining and oil and gas properties may take a variety of forms, it is usually on an option basis.[17] In part because of the high costs of direct mail and telephone solicitation in relation to the small amounts of new funds involved, only about 40% of the total funds raised go to corporate treasuries, the balance going to dealer costs and profits. When it is considered that public interest in these shares usually becomes most intense after the market has risen substantially above the issue price, the difference between the average price paid by the public and the amount actually finding its way into company treasuries may be even greater. Moreover, our concern about the appropriateness of this means of financing is heightened by the conclusion of a study prepared for us that of the approximately $340 million of cash raised for junior mining treasuries (i.e. after deduction of expenses) by such underwritings in the 1953-60 period, no more than $150-$160 million was actually spent on exploration by those companies.[18] If the $340 million represented 40% of the amount paid by the public, the public paid over $750 million to finance this amount of exploration—odds which are highly unfavourable in view of the fairly remote chance of such enterprises ever getting into production and paying back more than was put into them in the first place.[19]

As some 86% of prospecting expenses each year are now in fact made by producing mines, and as large amounts of capital are now required to bring a property into production, the role of the stock exchanges in financing natural resource development through primary distribution is a questionable one. This is especially true since the independent prospectors remaining have sufficient potential financing sources to safeguard their bargaining power. Some recent mines, particularly uranium producers, were financed in this way, but in our view there is a considerable difference between raising funds from the public for the financing of large mining units with established ore reserves, substantial backing, and long-term contracts on the one hand and raising $25,000-$50,000 for a purely speculative enterprise which has no assured ability to finance itself to production even if something is found. Moreover, a disturbing feature of such underwriting is that the broker-dealer, by owning or controlling a large block of shares in such companies, in many cases controls the issuer. The possibilities of conflicting interests, market manipulation, and other activities such as treasury-robbing—i.e. selling claims or other assets to the company at inflated values, paying himself and his associates high

[17] Submission of Broker-Dealers' Association of Ontario.

[18] See the working paper, *Finance in the Mining Industry*.

[19] *Ibid.* From 1907 to 1953, over 400,000 claims were recorded in Ontario and 6,679 metal-mining companies were formed. Of these only 348 got into production—sometimes after repeated stock exchange promotions—and only 54 paid any dividends.

salaries and consulting fees, etc.—are both obvious and real in such circumstances.

While the stock exchanges are fully aware of these dangers and have taken many commendable and useful steps to try and protect the public from abuses, we do not believe they should lend themselves to primary distribution. In doing so, they lead many people to distrust all common stocks and discourage the provision of true venture and equity capital by Canadian investors. It is true that requiring junior exploration companies to issue a prospectus, file an audited statement, and comply with the regulations applying to other issuers would perhaps raise their costs and might lead to some additional delays, but it would also achieve the more important aim of protecting the public and encouraging bona fide equity investment. New issues would also be more carefully considered, and if this discourages some financing which is not seriously aimed at bringing natural resources into production in any event, there would scarcely be any loss to the economy. Clearly, such a proposal would also entail hiring additional skilled staff in the securities administrations.

In the meantime, the Toronto Stock Exchange ought to intensify its efforts to police the activities of the primary distributors in order to minimize their effects on the reputable majority of the securities industry. At present, junior companies—in addition to providing an annual report to their shareholders and the Exchange and to complying with other requirements relating to the payment of dividends and rights—must also notify the Exchange of any material change in their affairs. This is defined to include changes in management, directors and control, acquisition or sale of new properties or shares in other companies, new management contracts, etc. Such companies must also give notice of any new option or underwriting, and when primary distribution is contemplated they must comply with certain conditions and make full disclosure of all material facts in a "filing statement".[20] The more important of these requirements relate to the minimum size of underwriting (normally $30,000), the prohibition of options without a firm underwriting agreement, limits on the size, price and term of options, and provision for the acceleration of options if the price of the shares rises sharply. They also require full disclosure of beneficial interests and responsibility on the part of the underwriter for any sub-underwriter. These features are designed to minimize the possibility of market manipulation and ensure that reasonable sums are raised for the treasuries.

A filing statement committee meets weekly to review filing statements, and the underwriter may not proceed if his proposals are not acceptable or if they fail to disclose material facts relating to the company's property, past and proposed development expenditures, vendor's consideration, controlling interests, etc. Limitations are now also placed on non-arm's length transactions to try to curb treasury-robbing. The Exchange told us that this system was working reasonably well, although it takes up some 90% of the time devoted to self-regulation and led to complaints that it was being "too strict". However, one area where some strengthening is apparently needed is in the follow-up of such underwritings to ensure that the funds have been put to proper use. While we commend the Exchange for these efforts, a serious weakness in the system is that filing statements need not be delivered to the buyer of shares undergoing primary distribution, although the Exchange makes them available to member firms and the press. The buyer of such shares does not therefore have the protection and information provided by the prospectus which accompanies a new industrial issue—with the right of rescinding the transaction if a study of the prospectus reveals something unsatisfactory to the purchaser.[21] In view of these considerations, and the value which a listing has for unscrupulous promoters, we believe that all new issues should be sold off the exchanges under the direct supervision of the securities commission

[20] Submission of Toronto Stock Exchange, paras. 179-188.

[21] This right exists for seven days after delivery of the prospectus. See, for instance, Section 49 of The Securities Act of Ontario for full details.

with whom the final responsibility in any event lies.

It has been argued that the problem of self-regulation in Canada has been made more difficult by the absence of a single national exchange such as is found in London or New York. This may indeed be so, although most of the problems involved could be eliminated if the two main exchanges would co-operate more in future in raising listing and other standards. As can be seen from the following table, the Toronto exchange comes closest to being a national exchange, having over 70% of the value of all trading compared to the 84% of United States business done by the New York Stock Exchange. While there are small amounts of trading in Winnipeg, Calgary and Vancouver, the main volume of business has remained concentrated in Montreal and Toronto, with the latter tending to grow in relative importance in response to the westward shift of Canadian economic activity and the replacement of overseas countries by the United States as the primary source of external capital. The predominance of Toronto is also illustrated by the fact that between 60% and 75% of the stocks listed on the other exchanges are also listed on the Toronto Stock Exchange.[22] Listings which are

[22] Montreal 62%, Winnipeg 67%, Calgary 63%, Vancouver 73%. Toronto has further strengthened its position by setting up special market facilities where American residents may trade with each other in order to avoid incurring the "interest-equalization tax" proposed by the U.S. administration in 1963. Volume on this market has, however, remained small in its first few months of operation.

TABLE 17–2

VALUE OF SHARES TRADED ON CANADIAN EXCHANGES 1952–1961
($ Millions)

—	Toronto	Montreal[a]	Vancouver	Winnipeg	Calgary	Total
1952	1,109.7	593.6	40.2	1.1	52.1	1,796.7
1953	1,143.2	509.7	25.4	1.7	17.6	1,697.6
1954	1,349.7	766.0	32.1	3.0	16.5	2,167.3
1955	2,699.0	1,161.7	56.1	2.7	14.9	3,934.4
1956	2,510.8	1,164.2	59.9	1.1	24.2	3,760.2
1957	1,864.8	846.6	48.1	1.0	18.8	2,779.3
1958	1,505.9	544.1	43.1	1.0	9.6	2,103.7
1959	1,860.4	663.1	58.8	1.7	6.3	2,590.3
1960	1,223.3	481.3	35.3	1.6	2.8	1,744.3
1961	2,526.3	948.5	101.8	3.7	2.3	3,582.6

VALUE OF SHARES TRADED AS A PERCENTAGE OF TOTAL

—	Toronto	Montreal	Vancouver	Winnipeg	Calgary	Total
1952	61.8	33.0	2.2	0.06	2.9	100.0
1953	67.3	30.0	1.5	0.10	1.1	100.0
1954	62.2	35.3	1.6	0.14	0.76	100.0
1955	68.6	29.5	1.4	0.07	0.38	100.0
1956	66.6	30.9	1.7	0.03	0.64	100.0
1957	67.0	30.5	1.7	0.04	0.67	100.0
1958	71.5	25.8	2.1	0.05	0.46	100.0
1959	71.8	25.6	2.3	0.07	0.24	100.0
1960	70.1	27.6	2.0	0.09	0.16	100.0
1961	70.5	26.5	2.8	0.10	0.06	100.0

[a]The Montreal Stock Exchanges' figures for 1952–57 are inflated but to an unknown degree.

SOURCES: Briefs of the Toronto and Vancouver Stock Exchanges. Data for the other exchanges were provided on request.

found only on the western exchanges are usually local mining, oil, and industrial companies with a local following that are not widely known across the country.

While a single national exchange would concentrate all trading, cause the markets to be broader and more resilient, and might reduce trading costs per unit, it would fail to take account of the country's significant regional variety and of the need for local exchanges to provide a centre for the shares of smaller and less nationally-known companies. Some of these exchanges also provide convenient centres for trading national stocks after the main eastern markets have closed. It might thus be constructive if the Toronto exchange were to do more to encourage associate members from other centres to join the exchange and accept its standards in return for a reasonable share of the commission business they generated. We are not, however, in favour of measures such as the elimination of arbitrage between exchanges, a rule which Toronto has considered introducing. Arbitrage takes place when prices in two market centres temporarily diverge and a member trading for his own account buys in one market and sells in the other. In doing so he of course makes a profit but, more important, his activity equalizes prices in both markets. This can also occur if the broker places a client's order in whichever market the best "fill" or price can be obtained, normally the most active market in that issue. He should naturally be required to do so where possible, but it is not always feasible to find out which market has the most favourable price. The arbitrageur thus has a useful role to play in the interests of investors as a whole, even though in the trade for which he acts he prevents a single investor, and that investor's broker, from getting the best price possible. While the New York Stock Exchange has prohibited arbitrage between itself and other markets in the United States, we believe arbitrage can play a useful function in the Canadian situation, especially if measures are taken to ensure that brokers execute orders in the best market where possible. Moreover, its existence need not impede any natural or desirable development for one or more markets to develop as primary national centres for the trading of particular issues.

The main exchanges have greatly strengthened their trading standards and raised the ethics of their members in recent years, and have also showed themselves increasingly aware of their responsibilities to both the investing public and the broader national community. Trading facilities have been modernized and improved and further progress lies ahead, even though the day when all trading will be carried out through computers rather than any personal agreement on a trading floor is not yet at hand. In a further attempt to reduce the costs and inconvenience of trading, the exchanges are exploring with the trust companies the possibility of establishing a central depositary to hold share certificates and reduce transfer, delivery and safe-keeping fees. The trust companies so far have been reluctant to make the necessary price concessions, and many other problems remain to be solved, but this service to the investing public may ultimately prove worthwhile.

SECURITIES LEGISLATION AND REGULATION

We have suggested a number of areas in which the exchanges might further improve their standards and encourage informed equity investment by the public, but because it is a field in which hanky-panky at the fringes is temptingly easy there is also a role to be played by the securities commissions and laws. If broader ownership of Canadian equities is desirable and if larger numbers of people are to be encouraged to invest in common shares to provide Canadian businesses with equity capital at moderate cost, several conditions must be met. The public must have the means and the knowledge to make such investments without undue expense; corporations must believe in broader ownership, recognize the importance of individual investors as a source of growth capital and be willing to provide them

with the information necessary to make sound investment decisions; and the brokerage and financial community must be competent to serve the needs of the investing public and command their full confidence. The role of securities regulation is to assist and encourage the securities industry to develop and maintain a deserved reputation for skill and integrity, to protect investors from deception by either the financial community or corporate "insiders" who stand in a fiduciary relation to them, and to ensure that adequate information is made available to them to allocate their savings rationally. The provincial securities administrations have, along with the industry itself, done much to raise industry standards and improve the disclosure requirements of prospectuses, but we have discovered areas where substantial improvements might still be made.

The philosophy of securities regulation in Canada is based on two principles, full disclosure and the prevention of fraud, although neither is fully implemented. The first is supported by securities and company legislation and the regulations of the stock exchanges, while the second rests on the preventive and punitive powers of the securities laws and the federal Criminal Code as well as those of the by-laws and regulations of the self-regulating associations. In Canada, unlike the United States, the full disclosure principle is supplemented by giving the securities administrators discretion to refuse registration of an issue even when the disclosure is "full, true and plain" if it fails to meet other standards. Unlike the United States also, direct securities regulation in Canada has been implemented exclusively through provincial acts administered by provincial securities commissions or, in a few instances, by a branch of the Attorney-General's department. In addition, of course, both federal and provincial company legislation impinges indirectly in this area, as does the Criminal Code of Canada.

Our studies of the securities administrations across Canada revealed that they are inadequately staffed both in quantity and quality, that salary scales have not been attractive enough in general to interest and retain sufficient able and experienced men, and that few securities commissioners have had much practical industry or regulatory experience prior to their appointments. The understaffing problem is exemplified in the Ontario Securities Commission which, with an effective registry staff of about five, in their 1961 fiscal year registered some 345 prospectuses, many of which went through several drafts, and considered but failed to register others. In addition, it registered 387 brokers, dealers and security issuers—56 of whom were new applicants—and 2,418 salesmen, 529 of whom were new applicants. Indeed, the 10,800 salesmen registered across Canada in 1961 received only a cursory glance by the securities administrations. About one-third of these were mutual fund salesmen who were not at that time operating within the framework of a self-regulating association. With the exception of Ontario, the securities administrations were able to provide us with only the most limited historical data about their registrations, again reflecting persistent shortages of staff. Indeed, some of the Commissions have no one on their staff who is in a position to analyse financial reports. Some of these problems may be inevitable with the fragmentation of administration over ten jurisdictions, some of which do not have sufficient securities activity to warrant trained full-time staffs. In general, however, securities administration seems to have been a low priority item for provincial governments, a fact which is reflected in the particularly low salaries paid for legal, administrative, and accounting skills: for example, the registrar, the chief full-time officer, is paid only between $6,000 and $10,000 depending on the jurisdiction.

One of the principal objectives of some of the administrators and practically all the brokers, dealers and corporation lawyers is uniformity of legislation across Canada. Some faltering progress is being made; the Alberta, British Columbia and Saskatchewan acts have been modelled on the Ontario act although in no case has the Ontario act been adopted without at least several minor changes. The Quebec act is much like the Ontario act although it provides the com-

missioners with greater powers. The securities issuer seeking a national distribution for a new issue is thus faced not only with the requirement of registration under ten securities acts which are dissimilar in varying degrees but with the requirements of the relevant companies legislation, although the administrators of the latter seem to fulfill only the functions of a registrar, accepting filings with little regard for their accuracy or completeness. In some instances, these or other authorities are responsible for prospectus clearance—for example, utilities issues in British Columbia are cleared by the Public Utilities Commission, a function we think would be better performed by a securities commission.

This hodgepodge of legislation increases the legal difficulties of bringing a new issue to market and leaves the issuer and underwriter open to the risk of delay caused by the failure to meet the requirements of a single jurisdiction, although in fact most administrators will register quickly prospectuses which have been accepted by the Ontario Commission; such co-operation, however, cannot always be counted on. Even where the legislation is similar, the discretionary powers allowed the commissions and adequacy with which they are staffed can result in important differences in administrative practices. We were told that, "substantive security law is comparable to the visible part of the iceberg, while the procedural law and policy represent the submerged mass. So long as such discretions exist (our) experience would indicate that true uniformity can never be realized".[23]

In 1963, the provincial administrators began to meet semi-annually rather than annually to discuss the policies and problems of securities regulation. Between meetings they exchange information pertaining to registration and enforcement of the anti-fraud laws, an arrangement which has worked fairly well in the past, although more frequent meetings might well provide for closer personal relationships and still better co-operation. Moreover, all the securities acts, except that of New Brunswick, provide for the execution of warrants for arrest issued by another provincial jurisdiction, a provision designed to prevent offenders avoiding arrest merely by moving to another province. There have been occasions, however, when the experience or warnings of other jurisdictions have gone unheeded and known racketeers have been left free to operate. In part this reflected inadequate staffs and faulty co-ordination, but this situation sometimes also arose because some governments were apparently unwilling to run the risk of taking action that they believed might diminish natural resource exploration and development in their province.

Co-operation between the provincial securities administrators and the United States national Securities and Exchange Commission (S.E.C.) has been irregular but has improved in recent years. Perhaps the major problem bedevilling relationships was the high-pressure telephone selling from Canada of speculative mining stocks in the United States market. In many instances, such sales were not contrary to Canadian legislation although they were in breach of the United States securities laws. The American authorities attempted to stem the flood by returning to the sender any mail addressed to Canadian broker-dealers, but this proved a costly system of enforcement. In March 1961, the Broker-Dealers' Association of Ontario bowed to pressure from the provincial Securities Commission and the Toronto Stock Exchange (the latter had threatened to withdraw listing and membership privileges) and notified its members to make no securities solicitations or offerings which did not comply with the appropriate laws of the jurisdiction where offerings were being made. This prevented the broker-dealers from selling stock in the United States unless a prospectus was registered with the S.E.C.—a long, arduous and expensive process —and helped to close the market in other provinces. This virtual exclusion from the American market, where 75% of sales were previously made, was the principal factor in the recent sharp decline in broker-dealer activity.

As already indicated, the securities administrators have quite wide discretionary powers since the laws of all provinces leave the registration

[23] Submission of the Broker-Dealers' Association of Ontario, para. 56.

of dealers in securities to the judgment of the commissions and also give them the power to "suspend or cancel any registration if in their opinion it is in the public interest". The Ontario Act and those modelled on it further provide that the commissions may initiate sweeping investigations where a statement has been made under oath making it appear probable that a person or company has contravened the provisions of the Act or committed an offence under the Criminal Code in connection with a trade in securities. Without the receipt of a statement under oath, these commissions must receive an order from the Attorney General before an investigation can be undertaken, although the Quebec Commission may make an investigation at any time on its own authority. The commissions also have the right to freeze the assets of a person or company which they are about to investigate. While the range of discretion is broad, and must in our view remain so if the investing public is to be protected and quick action taken to safeguard them against a short-lived but virulent deception or market manipulation, it should also be accompanied by an adequate appeals procedure to guard against arbitrary and capricious actions.[24]

We have already stressed the important role played by self-regulation of the securities industry in Canada, a part made particularly significant by the inadequacies of the under-staffed securities administrations. We believe a substantial measure of self-regulation is vital, both because the industry possesses an intimate knowledge of its own workings and problems that no outside agency can hope to equal and because self-discipline helps to develop a broader sense of public responsibility. In this connection, we have made a number of suggestions which we hope will lead to still further improvement in the industry's general ethics, trading practices, and listing and disclosure standards. With few exceptions, we found the associations' audit and capital standards to be satisfactory, although we believe that other requirements for entry into the industry at both the firm and personal level could be raised. In this connection, the tightening by the I.D.A. of its control over salesmen and the establishment of an examination to set minimum educational requirements for new entrants is particularly to be welcomed and should be pushed further by all the self-regulating bodies. We also found that in some respects the disciplinary committees of the associations have adequate powers to reprimand, fine, suspend, or cancel the membership of a firm or individual registrant for infractions of their rules, although in others the position is not so clear. In general, however, a firm or individual cannot be put out of the securities business altogether unless the Securities Commission cancels its registration.

We believe the various securities commissions should take a more active role in these matters to ensure that the standards of the self-regulating associations are adequate in all respects and to ensure that they do not become either too lenient or too arbitrary with their members. It is for this reason that we suggest there be appeal provisions from the disciplinary and membership rulings of the self-governing bodies, even though we would not expect to see such rulings set aside unless there were clear grounds for doing so. This would in fact be quite similar to the relationship of the Ontario Securities Commission with the Broker-Dealers' Association of Ontario, whose act authorizes them to make regulations only "subject to the approval of the Ontario Securities Commission". Together, they have established regulations controlling maximum price spreads on option underwritings and escrow arrangements for shares paid for sale of properties or other services to mining and oil exploration and/or development companies. The Toronto Stock Exchange regulations on these matters, referred to earlier, were also developed after discussions with the Ontario Securities Commision. A more active role by the securities commissions would, in our view, put the final responsibility for governing the industry more squarely on their shoulders while still maintaining the many advantages of intelligent self-regulation by the industry itself.

[24] The Ontario Securities Act was amended in the Spring of 1963 to improve and extend the coverage of the appeals procedure in the Act.

THE DESIRABILITY OF UNIFORMITY

The desirability of uniform legislation and administration for the Canadian securities industry was stressed by many of our witnesses. Such uniformity would facilitate the preparation and distribution of new issues, the trading of outstanding securities, and the enforcement of uniformly high standards of disclosure, competence and ethics. This might be achieved either by establishing a national agency under federal legislation which would take over the major responsibility in this area from the provinces, or by provincial co-operation to implement a uniform act and regulations across Canada. Neither proposal would achieve its aim unless the legislation were soundly conceived and intelligently enforced by securities commissioners and officials of undoubted capacity, while the latter would also entail the various commissions working very closely together to attain uniform standards of administration and enforcement.

We suggest that the federal government ought to use its influence to encourage the development of high and uniform standards of security legislation and regulation in Canada. Progress by the provinces themselves has been slow and no formal committee has been established by these governments to bring about a uniform securities act. Moreover, even though such a committee was established to draft a uniform companies act and has met intermittently for several years, the two drafts it has produced are still far from being accepted by the governments concerned. This work has been given low priority by many governments and a committee to draft uniform securities legislation would undoubtedly receive the same treatment. We believe that the federal government might provide the needed leadership by establishing a federal regulatory agency which might at first require only registration of issues being distributed interprovincially and internationally. In co-operation with the provincial administrations and the Royal Canadian Mounted Police, it might also enforce the securities fraud clauses of the federal Criminal Code.

In time, the federal agency might open regional offices to facilitate its operations, especially if some of the provincial governments found it practical and desirable to delegate at least some of their responsibilities to the federal body. While our recommendation therefore requires the establishment of an eleventh regulatory body in the first instance, it is our hope that it will eventually lead to agreement and co-operation which will eliminate much of the existing duplication and lack of uniformity. This might be achieved quickly, especially if high federal standards lead provincial governments to clear automatically issues which have been federally registered. This would give the provincial administrations more time to deal with local matters such as the licensing of security dealers and their salesmen and the registration of issues to be offered only within their own province.

In addition to the uniform high standards that a federal agency would establish within its sphere of operation, it might lead—as did the establishment of the S.E.C. in the United States—to a raising of standards in other jurisdictions. Indeed, as we were told on many occasions, the existence of S.E.C. rules and regulations has played a significant role in raising Canadian standards of disclosure, ethics, and securities regulation generally. Moreover, by establishing closer control over international securities transactions, a federal securities agency might help to attract both the sound portfolio investment from abroad and the expanded capital from domestic sources which will be needed for our continued development. Co-operation with the S.E.C. could also be more readily improved and maintained, a not unimportant consideration in these days when fraudulent securities operations are often carried out on an international scale. Also, for the first time a single agency would be responsible for and interested in the growth, development and efficiency of the whole Canadian securities industry. In this connection, the federal body might be made responsible for collecting data on the industry's general financial and inventory position and on the extent of activity in the secondary market for bonds and in the over-the-counter market for stocks as well as other industry statis-

tics useful to the public, monetary authorities and the industry itself. In brief, we believe establishment of a federal regulatory body working in co-operation with provincial administrations could lead to higher standards, both in the industry and in the securities commissions, to better enforcement of the laws, to improved investor information, and to a reduction in duplication.

The principal arguments against a federal regulatory body are that it might become unduly bureaucratic and costly and that most security regulation problems are only of local or regional significance and best dealt with at the provincial level. However, the industry itself agreed that a single federal agency would be preferable to ten provincial agencies, and there is no inherent reason for believing that a federal agency would lead to costly delays, especially if sufficient latitude were given to its regional officials. As to the second argument, it seems to us that the experience of the S.E.C. and the fact that the Canadian securities administrators have recently found it necessary to increase the frequency of their meetings and tighten their co-operation indicate that a great many problems are more than local. Moreover, speculative capital raised in one province is often spent in another, and we would not consider, for example, that the raising of funds for oil exploration is a matter of interest only to the oil-producing provinces, nor that securities abuses in one jurisdiction are of no concern to the others. We are thus led to the conclusion that, despite the improvements which have taken place in provincial co-operation and despite the devotion, reasonableness and unstinting efforts of some of the securities administrators, the job which remains to be done is likely to be accomplished most effectively if a federal agency takes the lead in setting high and uniform national standards.

We recognize the danger that a federal body might take the image of the S.E.C. which, despite its undoubted usefulness, exercises a highly detailed and comprehensive control over trading in securities in the United States. Indeed, its staff numbers well over 1,000 and it has annual appropriations of about $11 million, only a little over 30% of which is covered by fees collected.[25] However, the S.E.C. was born in the midst of a depression marked by collapsing securities markets in which there had been widespread trading abuses and fraudulent practices. The present Canadian situation is sufficiently different that comparisons are not likely to be fruitful. We hope, therefore, that a Canadian federal agency, supported by the existing self-regulatory associations, would be able to avoid some of the excesses of detail and delay that have been experienced by the S.E.C., particularly in the area of prospectus registrations.

IMPROVING INVESTOR PROTECTION

We have already discussed a number of inadequacies in the existing securities or companies legislation and administration, detailed remedies for which have been discussed by interested parties and outside observers in Canada and other countries. It is not our intention to review all these arguments fully here, but we would like to set out briefly the main areas which seem to us to call for improvement.

(i) *Disclosure and Related Matters*

Standards of disclosure in this country are still generally inadequate. Even in the case of prospectus requirements, where the greatest improvements have taken place, more information should be required on the salaries of executives and material contracts affecting the business, on the names of beneficial owners of 10% or more of the voting stock and how much they own, and on details of executive stock options, bonuses and pension plans. Most important, the financial statements accompanying the prospectus should be in the form normally required by good auditing standards and should contain sales figures. Canadian prospectuses would also be more comprehensible if they were prepared in the narrative style of United States prospectuses rather than in

[25] Established by the Securities Exchange Act of 1934 to administer that Act and the Securities Act of 1933, it now administers in whole or part a total of seven acts.

a legalistic manner in which the statutory information is presented point by point in a way which often deters the reader.

The enforcement of "full, true, and plain" disclosure ends in Canada with the securities acts: as representatives of the Chamber of Commerce and the investment industry told us, the provisions of the companies acts are neither so exacting nor so well enforced. In our view, companies should be required under these acts to provide annually prompt and comprehensive information containing sales figures, comparative data going back several years, and information about long-term lease payments and contingent liabilities such as obligations to unfunded pension plans.[26] Accounts of subsidiaries should be consolidated, and wherever there are securities of a subsidiary in the hands of the public, a balance sheet and profit and loss statement for the subsidiary should be published. Moreover, corporate financial data should be available, not necessarily in audited form, more frequently than once a year. While we are not prepared to recommend the legal requirement of quarterly reports at this time, such a step may well be necessary to arrive at standards of disclosure already practised in the United States and essential to the development of an informed investing public. These are matters in which the proposed federal agency could play an important and constructive role.

We believe that more stringent disclosure laws are essential if the stock exchanges are to be successful in their campaign to achieve more extensive and frequent corporate reporting in Canada. While the situation is improving, the attitude of too many corporations is that the intelligent and informed investor is a nuisance rather than a partner in the enterprise and that, if necessary, listing on the stock exchanges could be sacrificed rather than provide the full disclosure found in the United States. Given this attitude, and the fears that interim or sales information will be of benefit and interest only to a company's competitors, some legal sanction is necessary. That full financial disclosure is not harmful or misleading is shown by the fact that virtually all listed companies in New York provide their shareholders with sales and quarterly financial statements and that the 25% of Canadian companies which do so have had a favourable experience with the practice. Quite independently of stricter company laws, we think the stock exchanges should be more insistent on requiring high standards—we cannot believe that all companies whose disclosure practices are inadequate would be prepared calmly to contemplate delisting of their shares. In this connection, the Toronto Stock Exchange's provisions relating to the disclosure of material changes in a company's affairs could usefully be broadened to require more companies to inform their shareholders of such changes. Nevertheless, the requirements of company laws should be actively enforced and their administrators should work closely with the securities commissions and investment community to ensure full and continuous disclosure, to protect the rights of shareholders and to provide shareholders with sufficient information about their rights to enable them to protect themselves. Indeed, it may be found convenient to have the securities agencies act as the enforcement authority.

Requirements to disclose corporate "insider" trading are also extremely weak in Canada. The director or officer of a company is in an advantageous position to use special knowledge of the company's affairs for his own benefit, often to the disadvantage of the shareholders at large, yet the Ontario Corporations Act provides for the disclosure of directors' trading at an annual meeting only upon the request of a shareholder or shareholders representing at least one per cent of the issued capital of the company. This right appears to be little known, is seldom used, and its force is much impaired by the restriction that it can be exercised only once annually. The federal companies act goes further, requiring every director to "furnish annually to the secretary for the information of the shareholders" details of his transactions in the company's shares over the

[26] We also recommend that where capital cost allowances claimed for tax purposes exceed those recorded in the shareholders' accounts, the amount of the difference should be stated, both annually and cumulatively.

past twelve months. The phrase "for the information of shareholders" has been interpreted to mean that the information will be available only if requested. This law also prohibits directors from speculating in their companies' shares and provides a penalty for such speculation, which is not, however, defined. In the United States, insiders [27] are required to report monthly on transactions in their companies' stock, and these reports are made public; their trading profits from the sale of shares held for less tnan six months are recoverable by the company; and they are prohibited from selling the stock short. Moreover, a recent S.E.C. report to Congress recommends the extension of these policies to companies whose shares trade on the over-the-counter market.[28]

The Canadian shareholder is relatively exposed to insider abuse. We recommend therefore the adoption of disclosure requirements similar to those now in effect in the United States but extended to all public companies. These requirements might be included in the securities acts and administered by the securities commissions, although the stock exchanges should take an independent lead in this matter.[29] A similar tightening up in the enforcement of stock exchange and securities act provisions with respect to the dissemination of insider tips and rumours could well be carried out. Finally, the law should provide for fuller disclosure of how funds raised for natural resource exploration and development have actually been spent and should provide for express shareholder approval of all contracts with "insiders" or their agents.

Another and closely related problem on which we believe some legislation is necessary is that of take-over bids. New management or amalgamation can play an important role in improving the efficiency of Canadian corporations, but if brought about by take-overs there can be undesirable side effects if shareholders are not given the time or information necessary to judge the proposal on its merits. The directors of the company receiving the offer have a duty to protect the rights of all their shareholders in such circumstances, and particularly must be responsible to ensure that insiders do not take advantage of their special knowledge. We recommend therefore, that the companies acts be amended to give statutory effect to these responsibilities along the following lines:[30]

1. Secrecy should be maintained during the negotiations.
2. There should be no trading by a prospective bidder or by directors or their associates while negotiations are taking place.
3. Shareholders should be informed immediately an agreement has been reached.
4. The directors should satisfy themselves that the bidder can complete the transaction.
5. The directors should make a recommendation to the shareholders and indicate whether they propose to accept the offer.
6. Directors should ensure that all the shareholders are given a reasonable opportunity to consider the offer and that, if less than all shares proffered are accepted, shares are purchased pro rata from all shareholders meeting the offer's conditions.
7. The name of the buyer should be disclosed together with sufficient information about the future prospects of their own and the combined companies (if the offer is not for cash) to enable the shareholder to make a rational decision. This would include information not

[27] Directors, officers, and beneficial owners of more than 10% of any class of any equity security of companies listed on an exchange.

[28] *Special Study of Securities Markets, op. cit.*

[29] The recent report of the Jenkins Committee in the United Kingdom goes further, recommending that directors should be required to notify the company of any of their transactions in the company's shares within seven days of the transaction, the information to be registered and made available to the public; and that a director who in any transaction relating to the securities of his company or any other company of the same group makes use of confidential information that might be expected materially to affect the value of the securities should be liable to compensate a person who suffers from his action.

[30] These recommendations owe much to the voluntary *Code of Procedure on Take-Over Bids,* drafted in May 1963 by the Trust Companies Association of Canada, the I.D.A., and the Toronto, Montreal, Vancouver and Canadian Stock Exchanges.

only about the buyer but about any material change in the company since the last report to shareholders. It should also disclose any special management payments or pensions to be made to directors or officers of the company receiving the offer.

8. The conditions on which the offer becomes binding on the bidder or the conditions on which the bidder has the option of declaring it binding should be stated. If the offer is for all the shares the bidder should also state whether he intends to use Section 128 of the Companies Act (Canada) or one of the corresponding provisions of the provincial acts, where possible, to acquire minority shares.

9. If a commission is being paid in connection with the solicitation of acceptances, its amount should be disclosed.[31]

Another area where Canadian corporations, including mutualized insurance companies, are not required to fulfil their normal obligations to shareholders is in the solicitation of proxies. It was pointed out to us that notification of a shareholders' meeting in Canada all too often is confined to a brief and very general agenda and a request for a proxy signed in favour of the management.[32] Generally, no provision is made to allow the shareholder to direct the voting of his shares, either for directors or on particular issues, no space is provided for him to appoint any other person as his proxy, and no information is provided to enable him to form judgments about the matters on the agenda. As a consequence, investors are discouraged from taking a responsible and intelligent interest in their company.

We strongly urge, therefore, that both the stock exchanges and the securities commissions require that proxy material be expanded to include information on the qualifications and financial interests in the company of persons standing for election as directors, including any changes in their holdings of the company's shares in the previous twelve months. It should also set out the details of important measures to be proposed at the meeting in a full and objective manner. Finally, the proxy form should give the shareholder an opportunity to direct his votes. These provisions are all required of stocks listed in New York and their application in Canada could help to develop a more active and informed body of shareholders.

(ii) *Other Needed Measures*

One of the more glaring deficiencies of securities legislation which has become evident in recent years relates to the solicitation of short-term capital from the public by smaller financial institutions, usually dealing in mortgages or instalment receivables but sometimes in business lending as well. Many provincial securities acts exempt from registration all negotiable promissory notes or commercial paper maturing not more than a year from the date of issue. Moreover, some of these institutions solicit deposits, often offering high rates on these and other short-term liabilities (hence their sobriquet "the eight per centers"). While federal companies legislation prohibits companies chartered under it from engaging in the business of banking, banking has not been given a legal definition; similarly, the comparable Ontario and Quebec laws, as well as those of four other provinces,[33] have nothing to say about the acceptance of deposits or banking. The first step towards stemming abuses by these unregulated companies is obviously to withdraw securities act exemptions from those companies soliciting short-term liabilities in the form of notes from the general public, and at least four provinces[34] have recently taken the necessary action. These commissions, with their broad discretionary powers, are thus in a position to demand that such companies seeking registration maintain a reasonable level of capital to assets and of liquid assets to total liabilities and that full disclosure be made to purchasers of their liabili-

[31] A discussion and detailed proposals for the regulation of take-overs can be found also in *Notes on Amalgamation of British Business*, prepared by the Executive Committee of the Issuing Houses Association, and the *Jenkins Committee Report*, London, H.M.S.O. Cmnd. 1749.

[32] Submission of the Security Analysts' Association of Toronto.

[33] Prince Edward Island, Nova Scotia, New Brunswick and Manitoba.

[34] Ontario, Manitoba, Saskatchewan and British Columbia.

ties. Other provinces might well follow this lead. Ontario has also recently passed legislation providing for the regulation by the securities commission of companies accepting deposits, other than those already supervised. The securities commission must approve all advertising for deposits, receive quarterly reports from those accepting deposits, and has the right to inspect their books at any reasonable time. The act sets out high liquidity requirements related to the size of the deposit liability. We shall have more to say in succeeding chapters about the regulation of those who engage in the business of banking.

While we did not regard it as within our terms of reference to make a thorough study of the many facets of possible fraudulent or misleading securities activity and are thus not prepared to prescribe in detail on this subject, we did find evidence of some weaknesses in the regulatory framework. One of the principal deficiencies relates to the supervision of securities salesmen dealing with the public who are, with certain exceptions, registered with the securities administrations but who are not closely regulated by them. Indeed, almost anyone without a criminal record has been able to obtain registration and some fringe operators have gained entry to the business. Many mutual fund salesmen have had no experience in the securities industry, are working part time only, and are poorly-trained; moreover, the high rate of turnover of these salesmen has provided a chronic problem for the hard pressed securities administrators. One commission reported to us that the doubling of salesmen's registrations in the two years ending in 1961 was due almost entirely to the heavy influx of mutual fund salesmen.[35] During this period the sales agencies of mutual funds had no self-regulating organization. While the self-regulating associations should be required to establish high standards for the enlistment, training and supervision of their sales forces, and we hope the new mutual funds association will do so, there will still be gaps to be filled and overall supervision to be carried out by the securities commissions. These bodies will require more adequate staffs to do these jobs properly.

Some of the provincial securities laws, most notably that in Ontario, do not require registration of salesmen selling only exempt securities (mainly government issues) presumably on the principle that the quality of the product ensures the quality of the salesmen or at least minimizes the damage he can do. The validity of the principle is not obvious, and at least one known case of fraud has occurred in these circumstances. While Section 19 (3) of the Ontario legislation does provide for the removal of the registration exemption where the person or company has been guilty of acts or conduct not permitted to a registrant, this does not alter our view that the investor would be more adequately protected if all salesmen were registered. We recognize that this would necessitate a change in the Ontario requirement that salesmen must be full-time employees in the securities industry. Many exempt issues are in fact now efficiently distributed in rural areas by the use of part-time, exempt salesmen but this advantage would not be lost if registration were specifically provided for such salesmen.

Selling techniques, particularly the exposure of the public to high-pressure telephone selling by fringe operators, has in the past given the investment industry a bad name. Section 53 of the Ontario Act and similar sections in other provincial laws prohibit salesmen from calling at or telephoning to a residence except when the person being called is a close personal friend, business associate or a customer with whom the dealer or broker—or more usually the broker-dealer—has been in the habit of trading. Such calls are also allowed if a customer has requested information on that specific security in writing. We wish to support the continued need for such legislation, including that aimed at mutual fund salesmen, to prevent the harassment of the public. We would, however, urge the commissions to publish policy statements setting out how they would interpret in practice such phrases as "in the habit of trading".

We have already discussed the need for the stock exchanges to tighten up listing and de-

[35] In Quebec registrations grew from 1890 in 1959 to 3757 in 1961.

listing standards to protect both the public and the industry's own reputation. If virtually defunct companies, described as "company shells", remain listed on an exchange, they provide an opportunity for an unlisted speculative company to obtain a listing by merger or acquisition. The latter then issue shares without needing to meet the registration and disclosure requirements of the securities commissions and, sometimes, despite the filing statement requirement, the exchange's own listing standards. The worst abuses may be eliminated by our earlier recommendations that primary distribution through the exchanges be discontinued and that full registration for all new issues of shares be required. We strongly urge, nonetheless, that the stock exchanges require all listed companies to maintain current listing standards of the exchange or be de-listed, and that all listings be reviewed periodically to ensure that these standards are being maintained. Where an unlisted company merges with a listed company the new company should without exception be required to file a listing statement and meet the listing requirements of the exchange. If it fails to do so within a short period of time, it should be de-listed. Rules for the control of mergers have been established by the New York Stock Exchange and these might well be considered by the Canadian exchanges.

Little is known about the extent of market manipulation in Canada and we have not tried to undertake the sweeping and highly-detailed enquiry which would be required to establish the facts, although we have the impression that such activities are carried out by only a small minority of securities dealers. The Criminal Code provides for criminal liability arising from fraud (Section 323), false advertising (Section 306), wash sales (Section 325), bucket shop operations (Section 326), and sales of shares held for customers (Section 327).[36] The securities acts and the by-laws of the Toronto Stock Exchange cover much the same ground. However, only one conviction has been obtained under Section 325 of the Criminal Code, and in this case the accused pleaded guilty. One notable case was twice brought before the courts under this section and on each occasion the jury failed to reach a decision. There have been no charges laid under the relevant by-law of the Toronto Stock Exchange.

The major problems in this area seem to be inadequate policing, perhaps due to under-staffing of the securities administrations, and a reluctance to press charges in view of the difficulty of obtaining convictions under Section 325 of the Criminal Code which, unlike American legislation, requires that the "*intention* to create a false or misleading appearance of active public trading . . ." be proven. We believe the relevant provisions of the Criminal Code ought to be reviewed by the federal Department of Justice in consultation with the investment industry and securities administrators with a view to making the legislation stricter and easier to enforce. As under some provincial laws, the federal authorities might also be granted the power, subject to the proper safeguards and appeal procedures, to freeze the assets of those suspected of fraudulent operations contravening federal securities legislation when such a step is necessary to protect the interests of the public. This provision helped to save some funds for depositors in a recent case of fraudulent "eight per-center" activity.

Another area which we commend to the securities authorities for further consideration is that of regulations governing escrowed shares. These shares are paid by a company to a vendor, usually in exchange for property, although not necessarily so. Such shares are, in the instance of a new issue, required to be placed in the custody of a third party to be released according to the regulations of the securities commission. Their release is normally scheduled according to the various stages of the development of the company, in relation to the sale of treasury shares, or at fixed time intervals. Since the escrowed shares in most cases supplement a cash payment for a property of unknown value to the company, and since the

[36] Wash sales are orders to buy and sell placed with the intention of creating a misleading impression of public activity and interest in a security or to establish misleading market prices; bucket shop operations are those in which an agreement to buy or sell shares is entered into without the bona fide intention of executing the order or of making or receiving delivery.

vendor might be an "insider" or obtain effective control through such shares, special care needs to be taken to prevent abuses.

We have made a number of observations or recommendations in other chapters which are relevant to the subject of securities legislation, particularly in Chapter 10 when we noted the importance of the trust companies and authorities ensuring that the standards of investor protection in trust indentures be in no sense lax. We also made a recommendation in Chapter 16 designed to require disclosure when a chartered bank is an underwriter—a requirement now applying to other underwriters. Finally, we noted in Chapter 13 the possibility of conflicts of interest in mutual fund investment management and the problems of "front-end loading"—charging off all expenses in the early months of a long-term savings contract entered into with the buyer. Our view is that the public interest will best be served by requiring full, true and plain disclosure of these and other material facts so that the investor may judge for himself whether each fund's practices are sound. At the same time, the industry should raise its own standards of self-regulation and the securities administrators should take steps to ensure that all salesmen are properly qualified and that improper or fraudulent practices are prosecuted with vigour and dispatch.

Despite the weaknesses which still exist, we have been impressed by the improvements which have taken place in the functioning of the Canadian stock markets and by the responsible attitude shown by the great majority of the securities industry's members in their attempts to raise industry standards. We cannot stress enough the importance of high standards of industry self-government—relating to skills and competence as well as to ethics and financial responsibility—in achieving an informed and increasing body of Canadian investors willing to supply true venture capital to finance the nation's development. We have made a number of recommendations designed to serve this end and hope that they, and an expanded industry program of investor education, will bear fruit in the years ahead.

At the same time, more stringent disclosure and securities laws will be needed to support and encourage these efforts and to ensure that the broader public interest is protected. We have suggested establishment of a federal securities body to work in co-operation with the understaffed provincial administrations in bringing about high and uniform standards of regulation in a more flexible way than its American counterpart, and made proposals for improving existing regulations and standards of enforcement. None of the weaknesses to which we have pointed will be new to the industry and the responsible authorities, but we hope that our attention to them will speed the process of improving private and public regulation which is so vital to the achievement of a satisfactory and soundly allocated flow of Canadian investment funds.

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CHAPTER 18

AN APPROACH TO BANKING LEGISLATION

The changes in banking laws we will now recommend, like the various legislative and other recommendations made in earlier chapters, are designed to promote continued evolution of the financial system, to encourage it to be creative and competitive, and to ensure that it is sound. In our view, an appropriate regulatory environment is one which permits quick and efficient adaptation of our banking machinery to the changing needs of borrowers and lenders, while offering reasonable protection against loss or exploitation to those who deal with the banking institutions. At the same time, good banking legislation should also ensure that measures of monetary policy have an equitable and broadly predictable effect on the operations of the institutions concerned, and should encourage the development of effective contacts and consultation between them and the central bank. Finally, the framework of banking law should provide for a fair and acceptable pattern of regulation which does not discriminate among those doing an essentially similar business.

We have explained in earlier chapters that no regulatory framework can protect the investor in financial assets from losses if he is determined to speculate or if he does not investigate the financial position or reputation of the institutions with which he plans to deal. Nor can regulation guarantee that there will never be incompetent, negligent, or even dishonest management in the financial system, unless every transaction were to be investigated ahead of time and our economic life brought to a complete halt. Nevertheless, we believe the case for appropriate regulation of financial and banking institutions is not now in dispute: the workings of the financial system are complex and not always understood by its customers, and the handling of the public's funds for more or less prolonged periods of time opens possibilities of serious abuse in an unregulated system.

At the same time, we have indicated throughout the report that an effectively executed and well-designed system of regulation need not lead to excessively rigid and detailed procedures which increase the costs and reduce the efficiency and flexibility of the financial system. In our view, the goal of protecting the public against loss can best be achieved with three basic legislative safeguards—adequate disclosure, competent supervision, and legal powers giving the authorities the right to force the correction of unsound or careless practices and to prosecute those engaged in fraudulent or criminal activities. Complete and continuing disclosure of the affairs of institutions should enable the public without unreasonable cost and inconvenience to obtain the necessary information about the reputation and strength of any financial concern, while competent and frequent self-regulation under the ultimate supervision and inspection of government is the best safeguard against an institution becoming insolvent although—of course—not a guarantee that it will not do so.

Given these essential features of any regulatory system, one can take either of two broad approaches to other features of the legislation. Under the first, it would in principle be possible to devise a set of laws defining the markets in which institutions may operate in such a way that the needs of the moment are met and there is adequate competition within and between the various parts of the capital market. This approach puts limits on the types of business which may be conducted, the assets that may be acquired and liabilities that may be issued by any class of institution, and may lay down in fairly tight detail the terms on which even the circumscribed activities may be carried on. The legislation thus formalizes a particular pattern of specialization in the financial system, and involves the risk that in a changing economic environment the financial system will become unduly compartmentalized and will contain pockets of activity which are relatively free of vigorous competition. Even if the legislation is so carefully drawn that such consequences are avoided for the moment, it is certain that the community's needs will change. Although carefully drawn legislation could be modified from time to time, change and innovation will be impeded and institutions will be unable to become more efficient by adding to their services when they could otherwise do so at economic rates. In short, the financial system will not be able to do its job as well as it might. Moreover, if the terms on which some institutions are able to compete for funds are restricted by limits on their borrowing powers or on their assets and earnings, there is an added danger that changes in monetary policy will have a differential impact on their ability to attract funds and to meet the needs of borrowers who rely particularly on them.

We have argued earlier that detailed asset ratios and investment rules do not serve effectively to protect the public which deals with the institutions. It has also been pointed out that the Bank Act—the most effective of our regulatory laws—is relatively free of such restrictions and that those in the Quebec Savings Bank Act have been whittled down over the years. Indeed, some of the restrictions which remain in the two acts are contradictory, the one limiting mortgage investments and permitting business lending and the other in effect doing the reverse—even though the liabilities of the two classes of institutions are in large part identical. This is not to argue that some guide-lines as to cash, liquidity arrangements and certain types of assets are inappropriate—we will have recommendations to make on this subject later. We are, however, convinced that excessive use of asset ratios and investment rules adds little to the protection of the public and can have serious effects on the adaptability and competitiveness of the financial system. We therefore think it unwise to rely heavily on them.

An alternative approach recognizes the spread of competition and seeks to encourage it. A broader and less restrictive regulatory framework which permits each institution to do the sort of financial business it finds most profitable does not stand in the way of the system's competitive evolution. Nor does it replace legislated specialization with required uniformity. If institutions find that the flexibility stemming from smaller size, special skills, and continuous attention to one particular phase of financial activity gives them an edge on their more cumbersome competitors who have elected to follow the "department store" approach, they are entirely free to continue to conduct business in this manner. Moreover, if the community's needs for a particular type of financial service increase and it becomes attractive for the institutions to devote more resources to meeting them, they are all free to do so. Finally, this wider approach does not mean that the public is less well-protected. It does mean that much depends on the sound judgment of management and the government supervisors, particularly in meeting new developments in financial markets, but if properly conceived and administered it can provide sounder and more effective safeguards than a more detailed and less flexible framework.

Our legislative and other recommendations might well have been different had we found se-

rious "gaps" or deficiencies in the financial system or major evidence of failure to respond to competitive forces and the changing pressure of public demands. Had witnesses argued before us, for instance, that the facilities for export finance or for the provision of credit to consumers or some types of business were so inadequate that major reform was called for to ensure that the development of the economy was not hampered by its financial machinery, our approach might have been different. Convincing evidence of this sort, supported by our own studies, might have led us to recommend sweeping changes in the structure of the financial system, including the establishment of new institutions by private interests or government. We might have been persuaded that government should intervene more directly in financial activities to promote flows of capital to economic uses being neglected by the financial system; such intervention might be carried out by extending government guarantees, introducing subsidy and tax incentive schemes and by regulating the portfolio policies of institutions to ensure that particular borrowers had a captive market to which to turn. The inefficiency and inflexibility of such a system would impose heavy costs, but if the financial system were failing to perform its functions adequately, these costs might well be less than those of failing to take such action.

We have, however, had little evidence of this sort, and in fact the events of recent years have shown the Canadian financial system well able to adapt itself to the changing needs of the community it serves. We have been impressed with the extent to which institutions and markets have responded to new demands within the limits permitted by the laws which govern them, although no arrangement of the financial system can solve all our economic problems. The institutions and markets cannot conjure up goods and services, but can only facilitate their production and assist in allocating them among the multitude of competing demands. This being the case, we cannot expect that all borrowers will obtain the funds they want at prices they like, and it is therefore not surprising that we have heard suggestions that the needs of some types of borrower have been inadequately met. Well-founded as such suggestions may be, and they have all received serious consideration, it is significant that there were few of them and that they seemed to be directed not so much at major "gaps" in the spectrum of financial markets as at adjustments which might improve existing markets.

We have drawn attention to some of these problem areas in earlier chapters; for example, the difficulties which some small and remote municipal borrowers appear to encounter in attracting institutional funds.[1] However, we attribute this as much to absence of information on the borrowers' status as to biased investment policies. Similarly, it is undoubtedly true that the big mortgage institutions invest more freely in large than in small communities and that mortgage borrowers find it easier to obtain conventional mortgage funds in areas in which local mortgage institutions such as the caisses populaires are well established. This is an instance of the important role which smaller institutions with their knowledge of an interest in local situations can play in a balanced financial system, although the banks with their highly-developed branch systems could also play a part if the laws permitted. Despite these shortcomings, the broad statistical and other evidence supplied to us does not support the view that the national institutions follow investment policies which discriminate between different provinces or regions of the country, and many of them make conscious efforts to balance their investments regionally, not least because business considerations dictate that they do so.

It was also noted that some smaller business borrowers, in addition to needing somewhat freer access to medium and long-term finance and equity funds, would be greatly assisted if lending institutions were staffed and organized to offer them business information and management and financial advice as well as funds. There have been some important recent developments in this

[1] It will be recalled from Chapter 4 that in some regions these borrowers are able to attract funds on particularly favourable terms.

area of the market, but we hope to see more and have suggested that the Industrial Development Bank should put more emphasis on its role of advising small borrowers and encouraging private institutions to serve them and rather less on competing actively with private lenders in the field.

In our discussion of the residential mortgage market, we made a number of recommendations designed to free rates in the mortgage market—or at the very least make them considerably more flexible—improve the availability of information to investors and ease the restrictions on institutional lending. This approach should provide a larger and more regular flow of private funds into mortgages on new properties, permit the federal government's gradual withdrawal from direct mortgage lending to home owners and builders and bring the financing terms on new and existing property more closely into line. Taken with the changes already occurring in this market—such as the new arrangements under which loans of up to 80% of the appraised value of existing houses may be obtained at reasonable rates from reputable institutions—and our recommendations about mortgage lending by chartered banks discussed below, these should result in continuing substantial improvements in mortgage facilities in Canada.

In Chapter 13, we also put forward a number of other recommendations affecting the long-term institutions. These were intended to increase their investment freedom and flexibility to meet changing needs, while providing efficient government supervision. Changes in their valuation procedures and in the restrictive clauses of the insurance company legislation, particularly those relating to equity investment, should contribute to this end. The present arrangements for supervision of the insurance industry are satisfactory, but we referred to the need to ensure that pension funds are in an actuarially sound condition and that their investments meet certain broad tests of acceptability. We also drew attention to inadequacies in the regulation of mutual funds and welcomed the recent steps taken by the industry and the securities administrations in this area.

In some areas of the security markets, the problem is also to ensure that the freedom enjoyed in this central part of the financial system does not invite unsound or unethical practices and lead to the subsequent imposition of excessively rigid controls. Thus, we have recommended that securities regulation be greatly strengthened, that the federal authorities take the lead in bringing about inter-governmental co-operation in this important area and that a greater flow of information be provided for the borrowing and investing public. We drew attention to a number of specific abuses which should be controlled, but must emphasize again that success in combating them and ensuring the healthy development of stock and bond markets hinges no less on alert self-regulation than on sound supervision by well-staffed government agencies and adequate public information and disclosure. These measures, and the broader investment powers recommended for financial institutions, should also help to ensure that inadequacies in the financial system do not inhibit Canadians from investing in Canadian industry, although the heavy inflows of capital from abroad in much of the postwar period have resulted primarily from other causes.

Thus while the financial system has developed and changed enormously, there are a number of areas in which it functions imperfectly. In some instances lack of information or knowledge is responsible, in some cases institutional or investor attitudes have been slow to change or insufficiently venturesome, and in still others legislation and supervision have been inadequate. However, the most important source of these defects has been legislative rigidities such as those which prevent the institutions from adequately serving the conventional mortgage market or which inhibit the purchase of equities by life companies.

We turn now to the financial institutions which deal mainly in short and medium-term claims. Within the limits allowed by the legislation, the institutions concerned—the chartered and savings banks, trust and mortgage loan companies, sales finance and small loan companies, credit unions and caisses populaires as well as other institutions

not so easily classified—have diversified their activities and developed new lines of business. In the process, they have come into increasingly close competition with each other and the long-term institutions. Thus in the mortgage market, the chartered banks became an important lender for five years or so after their legislation was changed in 1954. Similarly, the savings banks entered the conventional and N.H.A. mortgage markets following amendment of their legislation in 1948 and 1954, the caisses populaires have become a substantial force in the mortgage market, and more recently some sales finance companies have found it profitable to establish mortgage departments or subsidiaries. These new lenders have at times offered strong competition to the life insurance, trust and loan companies which were formerly the only institutional lenders in this market.

In another lending market, the chartered banks have since 1957 so expanded their personal loan business that they are now the largest participants in a market which the sales finance companies had pioneered. At the same time, credit unions and—to a lesser extent—caisses populaires have catered increasingly to their members' personal financing needs, competing with the finance companies and small loan companies which specialize in cash lending. Because of the inroads of this competition, the finance companies have dramatically expanded their business lending, mainly in medium-term finance where the banks by tradition or as a result of restrictions were not very active. The banks are still the main source of short-term business finance but they have felt the impact of the growing commercial paper market on their lending to large borrowers, including loans to the sales finance companies themselves.

The institutions have also moved more aggressively into each other's borrowing markets. Trust and loan companies, credit unions and caisses populaires have all expanded their deposit borrowing, offering services basically no different from those of the chartered and savings banks. In addition to providing chequable and demand deposit facilities, the trust and loan companies compete for term accounts by offering attractive interest rates: the banks in turn have responded to this pressure and to that coming from the availability of finance company and commercial paper by raising the rates paid on certain of their notice deposits.

These examples of recent developments reflect a vigorous state of competition which has improved the efficiency of the financial system and provided better returns and lower costs of financial services to the community. At the same time, it should be recognized that this has given rise to problems of inadequate regulation and supervision of some of the deposit-taking institutions. Moreover, the banks have not always competed sharply on a rate basis and they and other institutions have sometimes not developed new borrowing and lending instruments as rapidly as might be desired. In part, as we argued in Chapter 7, this reflects the legal limitations under which the banks are placed in competing for funds because of the existence of the 6% ceiling and the prohibition on investing in conventional mortgages with their relatively high yields. In addition, the market in business term lending, especially to smaller businesses, has been inhibited by these factors as well as by the prohibitions on certain types of business lending applying to other institutions dealing in short-term claims. Moreover, as already suggested, the mortgage market has been significantly affected by the banks' inability to lend.

We would not want to overstate the impact of the legislation in restricting the services provided by the financial system or in lessening competition in some areas of the markets, but it is nevertheless clear that the legislation has had this effect. Indeed, the impact would have been more serious if the banking legislation had been differently interpreted, with the "near-banks" being prevented from soliciting deposits and the banks being prevented both from making personal loans at effective charges of over 6% and from investing in enterprises which make business and mortgage loans at higher rates. The increasing overlapping of functions between the short-term institutions, and the extra competition which it has brought, is a healthy and logical evolution, but it is neces-

sary to revise the legislation designed for an earlier stage in the history of the institutions concerned if it is to be in tune with the facts of market development and the needs of the country. The banks and the so-called "near-banks" now carry on essentially similar business. However, they do so under a variety of widely differing federal and provincial laws which inhibit desirable competition in some respects and prevent the institutions from serving the public as well as they might.

It is worth briefly recapitulating here the present legal and regulatory position in Canada. Section 91 of the British North America Act gives the federal government exclusive power to regulate currency and coinage; banking, incorporation of banks and the issue of paper money; savings banks; bills of exchange and promissory notes; interest; and legal tender. However, there is no definition of banking there or in any other Act, governments having neatly sidestepped the issue by "defining" banks as those institutions listed in Schedule A of the Bank Act and by naming the two savings banks in their legislation. The Inspector General of Banks told us of many legal cases involving the terms "bank" or "banking", but they also fail to provide any precise answer. As far as we have been able to determine, Canada is not alone, for we have not come across an exact definition of banking in the statutes of any country: in view of the difficulties of a narrower definition, some have legislation governing all "credit institutions", including banks.

The basic regulatory pattern in Canada can be traced back almost 100 years to the time when the provincial governments first enacted legislation governing the deposit-taking and related activities of loan and trust companies. The result of the federal government's acceptance of such provincial legislation—partly perhaps from a view that banking was confined to institutions with note-issuing powers—has been the emergence of a mixed and sometimes confused pattern of regulation. The federal government supervises the banks and savings banks listed in its legislation, some trust and loan companies, and certain activities of the small loan companies. Provinces regulate the other trust and loan companies and all credit unions and caisses populaires other than the recently established national central society (although the caisses tried in the early part of this century to persuade the federal government to extend its regulation to them). Moreover, some financial institutions are only governed by the general provisions of company law, as for example the sales finance and miscellaneous deposit companies. As a result of this rather haphazard approach there are illogical differences in legislation which prevent some institutions from contributing as they might to an efficient financial system and which lead to unevenness and inadequacies in the regulation and supervision of institutions now dealing with a large segment of the public.

IMPROVING THE FRAMEWORK OF BANKING LEGISLATION

Banking can be either a broad term or a narrow one. On some definitions it would embrace virtually all institutions other than the collectors of long-term savings, while on others it would be restricted to those issuing chequable deposit liabilities. However, the essential fact is that the borrowing and lending activities of those institutions which we in Canada happen by tradition to call banks and those of other institutions which we happen to call by other names have become very similar, and in some respects indistinguishable. Any distinction between the different institutions dealing in short-term claims is bound to be somewhat arbitrary, but the legislation must be drawn to reflect the basic reality that many of the activities of these institutions, whatever their names, overlap as they compete for funds and lending business. An efficient banking system, alert to the needs of all classes of borrower and saver and adjusting rapidly to changes in their requirements, will contain a variety of basically similar institutions, some dealing in a fairly broad range of markets and others specializing more narrowly. There must be sufficient competition among these institutions that borrowers and savers have alternatives open to them, but we have argued that

this will best be achieved under a system which applies equitably to all and enforces a minimum of legislated specialization.

The chartered banking legislation is in most respects soundly conceived, but it now applies to too narrow a group of institutions and contains a few restrictions which do not effectively contribute to the protection of the public and hinder the provision of needed financial services to the community. With these exceptions, however, we agree with its underlying philosophy. We therefore recommend that its system of inspection and supervision be extended to a broader group of institutions now doing essentially a banking business, some of them without adequate public safeguards. At the same time, we believe the legislation should leave the banking institutions free to borrow and lend as market forces and their own skills and preferences dictate, subject only to the requirements necessary to ensure the protection of the public and the efficient operation of financial policy. The following two sections discuss the extension of basically uniform banking legislation to a larger group of institutions, and the consequences of removing some of the main restrictions on their business, following which a third section discusses some of the legislative changes necessary to ensure that the banking system remains truly competitive.

(i) *More Comprehensive Federal Banking Regulation*

The difficult and technical question of defining banking, and of drawing the inevitably arbitrary dividing line between banking institutions and others, will be discussed in detail in the following chapter. However, our view is that it should be less arbitrary than the present legislation, which applies only to ten named institutions, and should encompass all financial institutions issuing demand liabilities, transferable and short-term deposits, and other short-term banking claims (subject to limited exceptions to be specified later). It would thus include the present chartered and savings banks, many trust and loan companies, some other deposit-taking institutions and such sales finance companies as issue banking claims not exempted by the legislation. It would also include the caisses populaires and credit unions, but we propose that it apply only to the central societies for the reasons set forth in Chapter 9.

We have concluded that federal regulation and supervision should apply to all institutions deemed to be banking institutions, and that all institutions not chartered or licensed by the authorities should not be permitted to engage in banking activities. Provincially-incorporated companies desiring banking powers would thus have two alternatives open to them—to apply to the federal parliament for a charter or to apply to the federal authorities for a licence to operate as banks; the latter procedure is used, for example, by provincially-incorporated money-lenders to which the Small Loans Act now applies. Some initial distinctions might be made between the powers of the present chartered and savings banks and other federally-incorporated banks on the one hand and other banking institutions on the other hand. These, however, may well turn out to be transitional, and for the most part both groups of institution would be free to carry on the same range of business and be subject to the same regulation.

An alternative approach would be to make federal regulation voluntary while offering inducements to institutions to submit themselves. Unfortunately, however, those few institutions which are now virtually unregulated are precisely the ones which are likely to remain outside the regulatory framework. In fact, the inducements of coming under good regulation and of using the name "bank" are probably not strong enough to lead all banking institutions to accept federal charters or licences. Many such institutions are already free to undertake most phases of banking business, in addition to some business from which the banks are excluded. They do not feel the need of central bank borrowing privileges because the chartered banks have served them effectively as lenders of last resort; they are unlikely to be attracted by the offer of a federal deposit insurance scheme because most of them believe they do not need it, while those for whom it might in fact

be desirable are quite likely to have their own reasons for refusing it and the regulation it would entail; improved or cheaper clearing arrangements for their deposit accounts might tempt some institutions, but most would no doubt continue to be able to come to terms with chartered banks for this service. Finally, the federal legislation might offer trust, loan and other companies a means of broadening their lending and borrowing powers, but the provinces could extend any powers not specifically declared to be subject solely to the federal authority. Thus while there is some attraction in a voluntary approach it is not likely to improve the present unsatisfactory state of affairs.

Another possibility would be to give the federal authorities standby power to bring the broader group of short-term institutions under regulation at a later date. However, we can see no merit in leaving some banking institutions outside a uniform regulatory framework because the public has thus far suffered only occasional losses. Moreover, the uncertainty which would be created by such an approach might have undesirable side effects and tempt some institutions to disguise their activities in order to avoid regulation. Thus, we conclude that federal regulation should be compulsory for all private institutions doing a banking business and that other institutions should be prohibited unequivocally from operating as banks, that is from accepting funds from the public in demand form or short-term accounts.

Federal legislation and supervision need not, indeed should not, be burdensome. The next chapter will discuss our view of the nature of this legislation, and such matters as the need for capital, cash and liquid asset ratios and their role in ensuring that the banking institutions are soundly run and suitably responsive to monetary measures. Our concern here, however, is with the broader investment philosophy of the banking legislation. The imposition of numerous balance sheet ratios achieves little in the way of protecting the public: ratios drawn broadly enough to allow investment flexibility may be almost meaningless, and those drawn narrowly may impair both competition and service to the public. The present chartered banking legislation has functioned well without them, while those applying to other institutions like the Quebec Savings Banks and trust and loan companies have had to be gradually whittled down as they became burdensome. We therefore see little advantage in building them into the legislative framework—indeed there might be serious disadvantages in doing so.

(ii) *Interest Ceilings and Mortgage and Other Lending Prohibitions*

The prohibition on conventional mortgage lending by chartered banks and the interest rate ceiling are the most serious barriers to free market forces in the present chartered banking legislation, while the restrictions on ordinary commercial and personal lending by trust and loan companies are the most significant restrictions imposed on other deposit-taking institutions: restrictions on business lending applying to caisses populaires and credit unions are of less importance in view of the unique demands of their members for financial services. We have already pointed out that there is no reason why the investment of a reasonable share of a bank's funds in mortgages should endanger its position and the safety of depositors' funds. At the same time, the entry of the chartered banks into conventional residential lending would do much to improve this part of the capital market: access to mortgage security would enable the banks to improve their service to business borrowers, particularly smaller enterprises. These are weighty arguments for removal of the prohibition.

The 6% interest rate ceiling introduces undesirable rigidity in the financial system and hampers and distorts the working of markets. It also has arbitrary effects on the institutions' competition for business and on their ability to serve the community well which were not contemplated when the ceiling was originally introduced and subsequently amended. We recommend that it be removed regardless of other changes in the legislation. The ceiling stands in the way of flexible lending by the banks in that it frequently prevents them from making loans on which higher rates must be charged to cover administrative costs and risks.

Obviously, this is to the banks' disadvantage; more importantly, however, it discriminates against borrowers such as small businesses which, if they are to obtain funds at all, must turn to other lenders which charge rates well above those the banks would ask if free to do so. As already noted, the banks have only been able to compete in the personal instalment loan market—in which they have substantially improved the facilities and lowered the average cost of funds—because the authorities have accepted what some might argue is a breach of the spirit of the 6% law. This, however, is not an argument for forcing the banks out of this business, but is instead one for amending an outdated law.

The distorting effects of the 6% ceiling have been most acute in periods of credit restraint when the banks have been prevented from raising their rates on loans and deposits in line with market forces. At such times they cannot compete equally for funds and thus have no choice but to resort to arbitrary rationing procedures in their lending. The problem is further complicated by the fact that borrowers tend to press in on the banks because their lending rates remain artificially attractive while others rise. We do not wish to suggest that interest rate freedom would remove the need for some non-price rationing of credit demands—in fact other institutions which are free to adjust their rates also select their investments partly on other grounds—but a free rate structure would contribute to a more rational response to changing market forces.[2]

There are three possible grounds for maintaining an interest rate ceiling on banking institutions —that it enhances control of the system by the monetary authorities, that it shelters other institutions from undesirable competition and that it protects small and inexperienced borrowers against exploitation. As we indicated, the ceiling will lead to severe bank rationing of credit if the authorities push market rates above it, but it is doubtful if it is a very useful aid in curbing credit flows and spending. Its main effect is to encourage credit to flow through channels less directly under the influence of the authorities. Moreover, its impact on those with no sources of credit but the banks is blunted by official urging to ration credit to these borrowers less severely than to those with alternative sources of funds. We will discuss the techniques of monetary control more fully in Chapter 22, but it can be said here that the imposition of interest rate ceilings is an uncertain and inequitable mechanism for controlling credit conditions and that there are more suitable ways of curbing bank lending directly if this should prove necessary.

None of the major competing institutions opposed the removal of the 6% ceiling on grounds that it would unduly injure their competitive position; most, in fact, explicitly recommended its removal on grounds of equity. Even if they had argued otherwise, we would not have been inclined to feel that the public interest would be served by sheltering higher-cost lenders from effective competition. Removal of the 6% ceiling would clearly extend competition and over time lead to substantial and desirable changes in banks' lending policies. However, the changes are unlikely to be abrupt or startling, although there would almost certainly be a comparatively rapid "fanning out" of lending rates, with well-secured short-term loans being made at low rates —perhaps lower than at present to meet the money market competition. On the other hand, riskier loans for longer terms would carry rates above 6%, but below those now charged by some lenders. When market rates are high, banks would undoubtedly raise their own lending charges but the force of competition and the higher deposit rates necessary to attract funds would temper the tendency for bank earnings to rise and thus limit the amount of additional business they are able to obtain.

[2] Interest rate ceilings on deposits, such as are found in some jurisdictions outside Canada, would also limit the ability of the institutions concerned to compete for funds and allow the unregulated institutions to improve their position in the market. They would lead to still further distortions and would play little if any role in ensuring the soundness of the banks. Interestingly, when the interest maximum applying to U.S. time deposits was recently raised, the result was to bring about a fall in mortgage and long-term interest rates because the institutions were able to attract more funds and employed them actively in those markets.

In our view, there is more merit in the argument that the uninformed borrower should be protected against the possibility of exploitation by being charged rates which are out of line with the costs and risks involved. At the same time, the imposition of unduly low ceilings only results in the discouragement of credit flows and drives these borrowers to unregulated and often extremely high-cost lenders. Since the present legislation on personal loan rates is in some respects inadequate, we believe that all cash lenders, not just the licensed small loan companies and money lenders, should be subject to regulations which prevent the charging of excessively high rates but still enable them to earn a reasonable profit. The banks, like other lenders, should be subject to such regulation: our recommendations on this subject are given in more detail in the following chapter.

It has been argued before us that if each institution were free to move into markets from which it has been excluded, the resulting freedom of the chartered banks to enter the mortgage market would give them an overwhelming advantage because of their size and financial strength, their extensive branch systems and their evident interest in expansion. If the present banks were in fact to increase significantly their share of financial business by expansion or by acquisition of existing companies, the financial system might become unduly concentrated and less competitive, thus defeating the main purpose of amending restrictive legislation.

It must first be recalled that the chartered banks have not in fact grown as rapidly as their competitors, partly because of their own competitive attitude and partly because the 6% ceiling, the mortgage prohibition, and—to a much lesser extent—the earnings foregone on required cash and liquid asset holdings have placed them at some disadvantage. The result has been that bank customers and those who might have borrowed from banks have either gone without the funds they wanted or have obtained them at higher rates from other sources. In these circumstances, other institutions have enjoyed the advantage of some protection from bank competition and the community has paid the price of this protection in the form of higher average borrowing rates and lower rates on deposits than might otherwise have prevailed in the financial system as a whole.

We are not persuaded, however, that other institutions have grown more rapidly than banks solely because they have been sheltered from the full force of competition in some areas of their business. A good measure of their success has been due to their own willingness and ability to experiment and innovate, to expand and reorganize their operations, and to enter new markets as circumstances have changed. In spite of restrictions laid on them by law—including for instance those which prevent trust and loan companies from competing with banks for attractive personal lending business and those which prevent finance companies from lowering their borrowing costs by accepting deposit funds from the public—these institutions have found ways of competing successfully. The same management skills will help them to adjust to new competition and take advantage of new opportunities.

Neither they nor the banks would all adjust rapidly or in the same way to the removal of these prohibitions. The bankers told us that they would react in different ways to the removal of present restrictions and that the nature of their business would not change overnight. There would undoubtedly be a desirable increase in term lending to small business secured by mortgages, and the banks would also begin to take on conventional residential mortgages. However, it is unlikely that they would shift the direction of their investment so drastically as to desert their present borrowing customers. Moreover, if they wish to establish a position in the residential mortgage market, they will have to be prepared to continue in it at all times, although naturally the size of their participation will vary. Thus, there are unlikely to be large and disrupting swings in the banks' mortgage lending such as have occurred with their N.H.A. lending when rates have risen above 6%. Quite apart from reluctance to court ill-will by making large and sudden shifts in their lending activi-

ties, it would take time to adjust the training and organization of bank staffs to meet the new opportunities. The problems of making these adjustments should not be exaggerated for the banks have already had experience as N.H.A. lenders and some of them are now moving indirectly into conventional mortgage lending through associated companies. Nonetheless, the present mortgage lending institutions would have some time to prepare for the new situation and those that wished to do so could take the steps necessary to enter fields of business, such as personal and business lending, which have been closed to them.

It must be recognized however that no one can be certain how big or how rapid a readjustment might result from removal of the mortgage prohibition. The economy is certain to benefit from the substantial N.H.A. lending by chartered banks which might follow removal of the 6% ceiling and from increased term lending, particularly to smaller business, which is now impeded by the ceiling and the mortgage prohibition. We have also put forward the view that bank entry into conventional residential mortgage lending would greatly improve the services available in this market. If it is demonstrated, however, that bank lending in this area would have so sudden an impact on other lenders as to hinder the long-run objective of developing a larger group of well-established banking institutions, some temporary limit might be placed on the annual rate of conventional residential lending by the present chartered banks. Any such temporary restriction would have to take account of the position of different banks. For instance an annual limit based on some percentage of assets might restrict small banks to the point that they could not develop a large enough business to justify the costs: the limit might therefore be the larger of some absolute amount or a specified share of assets. It would not be easy to devise a formula which would be flexible enough to allow for changing conditions and requirements in the conventional residential mortgage market from year to year while still providing some shelter to established lending institutions during the transition period. However, despite our reservations about both the principle and the practicability of such measures, some temporary regulations could be devised if a strong case were made that the long-run competitiveness of the financial system would otherwise be prejudiced.

Regardless of whether or not such transitional devices are used, some banks and other institutions will no doubt find it advantageous to specialize in one or another area where their skills and organization give them particular advantages. Indeed, the partially restricted areas in the capital market created by the present laws have not been without a considerable amount of this sort of diversification. Within the trust company industry, some companies have aggressively competed for deposit balances and short-term funds and developed their money market activities, while others have concentrated more exclusively on longer-term borrowing and mortgage investment. Sales finance companies have in differing degrees moved into such new types of business as capital lending, leasing, commercial financing and factoring as well as personal lending. Credit unions, as we have seen, are developing in a variety of ways according to local circumstances and their own preferences. It is very probable that this trend to a diversity of emphasis will continue. In fact, we would expect it to affect the banks themselves, which have so far all tended to develop along rather similar lines. In changed circumstances, some banks might attempt to offer a "complete" financial service, but others would probably choose to concentrate more of their attention on some lines of business than on others, since a bank which tried to meet the competition in all markets might find itself unable to deal as efficiently with customers as the institutions catering more directly to their individual needs.

It is undoubtedly true that in banking as in other businesses there are advantages in being big and in being able to provide specialized services in many fields. However there are disadvantages as well and we do not subscribe to the view that size alone will give the banks a necessary advantage. Among the chartered banks themselves this has not been the case, for banks have

grown at widely differing rates and the biggest have not always grown most rapidly. Banks, like other organizations, become increasingly difficult to manage efficiently as they grow, since it becomes less easy to reconcile the need for close co-ordination throughout the organization with that of keeping it alert to opportunities and able to capitalize on them quickly. There is undoubtedly an advantage for large businesses in dealing with a bank that is able to handle their credit needs without difficulty. It is our strong impression, however, that the big accounts are not necessarily the most profitable, for they can and do exert considerable pressure in bargaining with the banks. In any event, there is no reason why smaller banks and other institutions cannot compete successfully for all other types of business: indeed, they may handle large accounts by splitting them among a number of smaller institutions.

The revenue and expense positions of the different types of institution give some indication of their probable ability to stand up to new competitive pressures. After covering administrative expenses in 1961, the chartered banks had revenue equal to 2.80% of assets available for deposit interest, taxes, losses and shareholders' accounts. This was just about in line with the position of the caisses populaires, which provide financial services at the lowest overall cost, but substantially below those of trust, loan and sales finance companies. At the same time, the cost of borrowed funds was substantially lower for banks than for others. Their after tax earnings in relation to assets were lower than those of the trust, loan and sales finance companies, although about the same as caisse populaire earnings. It would appear that the trust and loan companies and the sales finance companies are in a position to meet stiffer bank competition out of their somewhat higher after-tax earnings. The provision of new services would of course raise the administrative costs of the trust and loan companies, but they would also be able to take on some high-yielding assets now denied them.

The impression that other institutions could compete successfully with the banks is strengthened by the fact that the latter's very low interest cost of borrowed funds—1.69% of assets—is a composite for current accounts, on which no explicit interest is paid, personal savings accounts, with an effective rate of 2.32% in 1961, and larger time deposits on which the average rate was close to 4%. For the reasons suggested in Chapter 7, the banks cannot expect to increase their cheapest borrowing—current accounts—very rapidly but will instead have to increase the rates on interest-bearing deposits and, no doubt, devise new types of accounts if they are to keep abreast of the others. It is likely, therefore, that the cost to banks of new funds will be higher relative to

SELECTED FINANCIAL RATIOS

(1961 fiscal years)

——	Chartered Banks	Quebec Savings Banks	Trust Cos.	Mortgage Loan Cos.	Caisses Populaires	Sales Finance Cos.
As a percent of total assets:						
Gross revenue	5.12	5.16	8.52[a]	6.79	5.08	9.68[b]
Salaries and other admin. expenses	2.32	1.94	3.42[a]	1.20	2.19	2.74[b]
Net	2.80	3.21	5.10	5.58	2.81	6.94
Payments on borrowed funds	1.69	2.26	3.48	3.58	2.34	3.69
Net profits after taxes and all other charges	.45	.39	.87	1.14	.55	1.39
Return on equity[c]	8.8%	9.0%	10.6%	8.3%	n.a.	11.0%

[a]Revenues and expenses associated with the management of estates, trusts and agency accounts are included.
[b]Net of certain acquisition costs amounting to 1% to 1½% of assets.
[c]General contingency reserves of the chartered and savings banks are not treated as equity in this calculation.

the average shown in the table than it will be for others, particularly as the latter have not always made full use of shorter-term market and deposit borrowing. Moreover, if other institutions begin to offer borrowing facilities comparable to those which now assist the banks in attracting funds, they may expect to broaden their appeal to deposit customers.

After-tax spreads on total assets have been fairly stable for each of the main groups of institution, although there has been evidence of some narrowing recently in the case of trust and loan companies. However the capital structure of some institutions has been changing, with the banks increasing their capitalization while trust and loan companies—although increasing the absolute amounts of capital—have reduced their equity ratios from the much higher levels which used to be maintained. At present, published shareholders' equity is equal to over 5% of total chartered bank funds, about 10% of trust company "banking" funds and about 15% in the case of the mortgage loan companies. The published rate of return on chartered bank equity has declined from a level of 11%-12% in most of the 1950's to 8.8% in 1961 and 9.9% in 1962, while the return on equity of the trust companies has risen to a level above that of the chartered banks: in the case of loan companies, however, the return is slightly less than that on bank equity. On the assumption that minimum capital ratios no longer apply to trust and loan companies, as we recommend in the following chapter, it would appear that these companies will have no difficulty either in attracting new capital or operating profitably.

These comments have not been intended to suggest that the banks' competitive position would be unimproved by the removal of present restrictions on them and their competitors. Even if the banks respond to interest rate freedom by lowering some interest charges while raising others, and even if they move rather slowly into conventional mortgage lending, there can be no doubt that their rate of gross revenues will increase over time. This will allow them to cover the cost of higher deposit rates which they must offer in order to attract additional funds. In any case, the banks or any other institutions can only increase their share of the market under competitive conditions by offering some combination of better service, lower lending rates and higher rates on savings than can be obtained elsewhere. The community as a whole stands to benefit from more open competition and it is this advantage rather than the comfort of any group of institutions which should be sought.

(iii) *Encouraging and Preserving a Competitive Banking System*

The vigorous competition which has improved efficiency and initiative in the Canadian financial system has been part of a world-wide phenomenon. There is much to suggest that the trend will continue, not least the growing international competition in all aspects of the financial business. Both money and ideas for its use move about the western world on an unprecedented scale. The steps which we propose towards freeing our institutions from legal restrictions are aimed at sustaining and promoting this competitive atmosphere in Canada.

At the same time, it should be remembered that competition is an uneasy state and that, however much they may thrive under it, businessmen have an inclination to protect themselves against it. We must therefore be alert to developments which would lessen competition or threaten its vigour. There are two areas to which we draw attention and in which we have proposals to make, the first that of agreements which limit competition among financial institutions and the second that of concentration in the financial system.

The most important agreements among the financial institutions are those governing interest rates paid and charged by the chartered banks. Banking is in many ways a highly competitive business marked by continuous efforts to improve the services offered to customers. On the lending side, this competition centres in the amounts and length of credits which individual banks will extend, but it is a fact that here, and in deposit

business, price competition among the chartered banks is severely limited. There is no evidence that they have resulted in excessive charges, but agreements covering borrowing and lending rates are undesirable in any circumstances because they contribute to inflexibility of rates and restrain innovations. As we have noted, both bank deposit and bank lending rates have been fairly rigid, and comparatively unresponsive to changes in credit conditions. The rigid rate structure has also inhibited the banks from venturing out in new directions, as for example in offering a greater variety of personal savings accounts. While these agreements are not the only reason why the banks have lost ground in the competitive race—the ceiling on interest rates and the restriction on mortgage lending are more important—they have probably been a contributory factor. They are thus bad for the banks and for their customers and should be prohibited. This being true, such a prohibition will have an added importance if the 6% interest-rate ceiling is removed.

To the extent that legislation itself can do so, it should prevent the spread of practices and arrangements which inhibit competition, and to this end we believe that certain prohibitions should be written into the law. First, we recommend that all agreements among banking institutions affecting the terms and conditions of borrowing or lending be prohibited unless specifically approved by the Minister of Finance. While it would be quite impossible to prevent members of a close financial community from discussing matters of common interest, the habit of formal or informal agreement can and should be broken. So far as we can determine, rate agreements serve no useful purpose in the public interest. It might be claimed that rates would otherwise be highly variable and uncertain but the evidence in the United States, where such agreements are not permitted, does not suggest that this would be a problem. The main borrowing and lending rates will tend towards uniformity as a result of competition, but we would expect banking institutions to establish a broader range of lending rates and to vary them more frequently in response to market forces if their decisions are arrived at independently. The prohibition should also cover agreements directly affecting competition for lending business, such as agreements not to take over accounts, which banks have entered into in periods of credit restriction, and other agreements affecting the cost of loans. If these or other agreements were considered to be in the public interest at certain times, they might be undertaken with the express approval of the Minister.

We have no strong views about agreements relating to banking procedures and charges for routine services. They have contributed to uniform standards of service without being used to enforce unduly high service charges, though it is not clear whether the result would be very different in the absence of agreements. However, we would recommend that any such agreements should be filed with the Inspector General, and he should bring to the Minister's attention any instances where he believes that agreements are against the public interest. The legislation should thus grant the Minister power to hold inquiries, to issue stop orders and to take such other action as may be necessary to prevent undesirable agreements.

Our interest in concentration of the financial system relates mainly to its effect on competition. In some areas there is a good deal of concentration: among several of the institutional groups we have considered a few firms do a large proportion of the business. In addition, there are links—increasing notably in the last few years—between institutions in different groups, the most important being those between the chartered banks and the trust companies. We have no evidence to suggest that this concentration has lessened competition and indeed the broad picture is one of increasing competition. Nor can we see any practical objection to the fact that the firms are often large and getting bigger. Sometimes, though not always, units need to be large to be efficient and competitive and to meet the growing forces of competition emanating from outside our borders: this is more true in the developing world of computers and specialists with its high overhead requirements than it has been in the past.

Nevertheless, in the light of recent tendencies a problem might develop. It will be recalled that each of the banks now has a close relationship involving interlocking directorates or effective control or both with a particular trust company. Banks have recently acquired interests in mortgage companies, a mortgage insurance company, an investment trust, and other enterprises making term loans. These ties have developed in part because of the restrictions in the Bank Act which have limited the banks' ability to operate in the developing fields of term and mortgage lending and thus their ability to pay the cost of holding their former share of deposit business. If our proposals are adopted the banks should be less inclined to acquire interests in other financial enterprises.

In view of this, and of the need to ensure that competition is not reduced by existing institutions acquiring control over their competitors and reducing unnecessarily the number of independent companies serving the public, we recommend that the legislation covering stock ownership and mergers be extended and that the law include limitations on common directorates.

The chartered banks—that is to say the present eight banks and any others acquiring full bank charters by Act of Parliament—should continue to be prohibited from owning shares in one another.[3] The savings banks and other banking institutions which will be required to obtain a federal banking licence, whatever the legislation under which they are now incorporated or under which they are regulated, should not be permitted to invest directly or indirectly[4] in the stock of another licensed banking institution or chartered or saving bank unless Treasury Board approval has been granted; a similar rule should apply to chartered bank investments in savings banks or licensed banking institutions. Moreover, all mergers or asset acquisitions involving any bank on either side of the transaction should also be subject to prior approval by the Treasury Board, as is now the case with chartered banks. Finally, all banks should be prohibited from acquiring more than 10% of the stock of any financial institution not subject to the banking legislation unless Treasury Board has approved the purchase.

Some qualifications to these rules would be necessary. The ownership prohibition should not apply to prevent the incorporation or establishment for reasons of corporate convenience of wholly-owned subsidiary companies carrying on business within a banking institution's own powers. Nor should it apply to ownership in foreign concerns operating outside Canada, or to companies now operating as essentially a single entity which happen to be set up in dual corporate form. In another direction, we would not wish to see the legislation inhibit useful innovations and improvements in the financial system by preventing or unduly restricting the participation of banking institutions in new joint ventures with other businesses or with other members of the financial community. In situations of this kind, of which there have been a few recently, Treasury Board approval might be almost automatically forthcoming provided that the institution concerned has less than a controlling interest. Another exception would relate to smaller concerns. We see no reason why there should be any interference with the development of corporate ties or amalgamations in terms of the public's interest in competition in cases where the combined published equity is less than say $10 million or such higher figure as may be appropriate. In some parts of the financial business, the development of larger units would improve efficiency and competition, and this process should certainly not be discouraged.

While transactions involving larger institutions would be subject to review in individual cases by the Treasury Board, we do not find it possible to be precise as to the circumstances in which the Board might exercise its power to waive the

[3] Section 75(2)(c) states that "a bank shall not, directly or indirectly . . . acquire, deal in or lend money on . . . the capital stock of the bank or any other bank."

[4] All limitations on equity investment should apply to investments by any subsidiary or affiliated companies (including parent holding companies), by groups of directors or by the institutions' pension funds: they should also cover any legal arrangements which give a bank effective ownership or equity in the earnings of other banking institutions. They should not, however, apply to E.T. & A. funds of the trust companies.

prohibition. It was, for instance, suggested to us that no institution should be permitted to obtain more than a specified share of its class of financial business by merger or acquisition of other companies. The arbitrary nature of any such rule and the implication that at some definite point size becomes an evil in itself seem to us to militate strongly against the usefulness of this approach, although we would expect the size of the institutions involved to be one of the considerations which the authorities would take into account. Exceptions might be made when one of the parties to an amalgamation is weak and its future doubtful or when it seems likely that an amalgamation or closer link would increase competition in the area concerned. Another consideration might have to do with a desire to keep control in Canada. There are a variety of possible considerations but the prime objective should be to maintain and increase competition in the financial system.

Our chief concern is not in trying to lay down rules by which future proposals in circumstances now unknown to us will be decided. Rather it is to ensure that the Treasury Board, with the advice of the Inspector General and others, have the opportunity to consider proposed changes and extensions in corporate ownership and functions among banking institutions before they become accomplished facts.

In order to ensure that the government has continuing control over developments affecting competition and concentration, the Treasury Board —or an officer or board it appoints for the purpose—should have power to review all situations where ownership links exist. This authority would cover situations resulting from prior decisions to make exceptions to the general rules. It should also empower the Board or its officials to enquire into the transactions involving banking institutions which have occurred in recent years and which would have required approval under the rules suggested above. In cases where the authorities find that the public interest is in jeopardy, they should have the power to apply effective remedies.

We also believe it desirable to clarify Section 75(2)(b) of the Bank Act which prohibits a bank from directly or indirectly dealing in goods, wares or merchandise or engaging in any trade or business. The purpose of this clause is primarily to ensure that banks do not over-extend themselves in fields in which they are not expert but it also acts to prevent extensive banking control of other businesses. We therefore recommend that a banking institution should be prohibited from holding more than 10% of the stock of any non-financial business, with the exception of subsidiaries established for its own corporate purposes such as companies owning the bank's real estate. A bank would be free to hold equity in excess of the limit if it had been acquired as additional collateral for an unsatisfactory loan or in the event of a forced takeover of a firm. As with the present rules regarding acquisitions of real property not needed for the bank's own business, banks should be required to dispose of such equity within seven years. In a related area we believe it unwise and undesirable for the executive officers of banking institutions to serve as directors of other commercial concerns, with the exception of subsidiaries or affiliates, but we do not feel that this practice warrants a legislative prohibition.

Close ties among competing institutions may depend on directorate relationships rather than ownership. We therefore recommend that the present accepted practice that chartered bank directors do not sit on more than one chartered bank board be embodied in the legislation. In addition, no banking institution should be permitted to draw more than one-fifth of its directors from the board, officers, or employees of any other single banking institution.[5] Present directors would be exempted from this restriction. However, we would not expect any common directors

[5] In view of the varying use of advisory committees by some institutions, consideration should be given to covering them as well. Exceptions to the general rule would be made in the case of wholly-owned subsidiaries or other special cases: for example, one savings bank has an affiliated trust company which is owned by its shareholders in proportion to their holdings in the bank itself, and we would see no reason why it should be obliged to meet the 20% rule although it is not formally a subsidiary.

to be maintained if two banking institutions came to compete directly with each other in virtually all phases of their business. Banking institutions, like other corporations, benefit substantially from the advice, judgment and business-getting powers of experienced directors. However, directors cannot perform these functions effectively if they are serving competing corporations at the same time, and the net result may be an unnecessary and undesirable reduction of competition.

We have carefully considered the merits of permitting the present chartered banks to apply to the provinces for trustee powers. In view of the fact that there is no evidence of an immediate need for addditional trustee facilities, and bearing in mind that the banks did not request this power, we do not recommend that they be authorized in the coming revision of the legislation to seek it. The other legislative changes recommended will give all banking institutions a wide range of common powers and lead ultimately to substantial shifts in the competitive positions of different institutions. We see merit in a gradual approach to the trustee business in these circumstances, since there might be some tendency for the banks to move too abruptly into the business, not necessarily because they believed it profitable to do so, but in order to match each other's services in a rapidly changing financial environment. The other adjustments which we propose are substantial and in our view important and fairly urgent. At some time in the future—probably a later Bank Act revision —it might be appropriate to give the banks power to go into the trust business. Since the trust companies will be free to go into the banking business without restriction,[6] there would in time be a certain competitive inequity in preventing the banks from entering the trust business but this should not be a serious problem for a while.

We have suggested a legislative framework in which the banks will be freed of burdensome restrictions and rigidities on their ability to compete for business at home and abroad and in which services provided to the public will not be restricted by the imperfections resulting from compartmentalization of the market. The different banking institutions will still be free to have ordinary business dealings with each other and moreover will have the freedom to undertake new lines of business now closed to them. While there will be no legislation against size as such—which we believe would be undesirable—the institutions will not be free to enter these new fields through purchases or mergers which reduce the number of independent competitors—unless they are able to persuade the Treasury Board that the public interest is served by their doing so. Nor will they be free to acquire or retain unrestricted ownership or directorate connections or engage in uncompetitive practices which could make for too much comfort and too little challenge in the financial system.

[6] We have argued in Chapter 10 that there is no necessary incompatibility between banking functions and trustee powers —indeed, the experience of the trust companies shows the reverse. We did, however, lay stress on the importance of considering the interests of trust accounts first and of putting all securities transactions through impersonal markets.

FOREIGN BANKING IN CANADA

In part allied to the broad question of the competitiveness of the Canadian banking system, and to the more specific matter of one bank owning another, is the subject of foreign banking in Canada. Despite the fact that Canadian banks do a substantial business in other countries, our banking legislation has never made formal provision for the establishment of agencies by foreign banks. Some representative offices have in fact been set up under names which do not include the word "bank"—which is restricted to chartered and saving banks—and others do substantial business through their representatives who visit Canadian customers. One Canadian bank was established by Dutch banking interests in 1953, and in 1963 a substantial block of its share capital was acquired by an American bank.

We believe that foreign banks should be able to apply for the right to open agencies which would be free to conduct all phases of their business, other than the acceptance of deposits in Canada: this would be comparable to the position of agencies of foreign banks in New York. Such

offices would be confined to the main financial centres and licences would be required. Such licences should be granted only if the foreign bank concerned has demonstrated to the authorities that the additional facilities are necessary to its agency business and will be a useful addition to banking services in Canada. The agencies would report to the Inspector General of Banks who would have the right to examine their affairs to see that they were not engaging in prohibited business or otherwise harming the public interest.

This change in our banking legislation might open the way for some improvement in the banking facilities available to Canadians and ensure that all foreign banks operating in Canada are subject to appropriate reporting to the banking authorities and inspection by them. Finally, and not unimportantly, it might reduce the pressure on foreign banks, particularly American banks, to acquire ownership in Canadian financial institutions in order to promote their business interests in Canada.

The ownership of Canadian banks by non-residents raises other considerations. The shares of all Canadian banks but the one owned by Dutch and American banking interests trade freely on stock exchanges. Ownership is widely distributed and a high proportion is registered in Canada: in 1961, 93% of individual holdings were under 500 shares and 76% of all bank shares were registered in Canada. Ownership of bank stock by individual non-residents does not seem to us much different in its direct consequences than ownership by a similar broad group of Canadian residents. Widespread ownership, whether domestic or foreign, reduces the concentration of shareholder power in this vital sector of the economy.

Ownership of one bank by another is a somewhat different matter. While this has been prohibited among Canadian chartered banks, and should continue to be, no such prohibition applies to the acquisition of part or all of a Canadian bank's capital by foreign banks. Of course, if foreign banking interests want to establish a new bank in Canada, they—like any other group—are required to obtain Treasury Board approval. However, there is no provision for the authorities to control in any way their buying stock in an existing bank and thus acquiring an established position in the Canadian banking system. Having regard to the large concentrations of economic and financial power which are sometimes centered in large foreign banks, we regard this as an anomaly which should be corrected.

The infusion of new financial initiative and management by foreign banking interests might in some circumstances improve the Canadian banking system. On the other hand, foreign-owned banks—especially those controlled in the United States—might be in a position to obtain the business of firms whose parent companies already deal with the parent bank, without offering better or cheaper service in our banking market. Allocation of business for non-economic reasons might not occur on a wide scale since large firms can and do normally deal with a number of banks and should be well able to resist pressures which are against their interests. Moreover, the Canadian banks being large themselves would undoubtedly resist such a tendency. Nevertheless, some danger of undesirable practices in competing for accounts does exist.

Another disadvantage of foreign bank ownership which has been suggested[7] is that these banks might be less sympathetic than those controlled in Canada to the wishes and policies of the Canadian monetary authorities. They would, of course, be subject to the same regulation and control as those owned in Canada and would be affected in the same way by policy actions. Nor would they in practice have much easier access to foreign funds in conditions of monetary stringency than the Canadian-owned banks with their extensive operations in foreign markets.

We think a high degree of Canadian ownership of financial institutions is in itself healthy and desirable, and that the balance of advantage is against foreign control of Canadian banks. Further, we have recommended that stock ownership by one Canadian bank in another be subject to governmental control. For all these reasons, we recommend that all direct or indirect acquisi-

[7] See, for instance, the *Report of the Royal Commission on Canada's Economic Prospects*, page 397.

tions of shares of Canadian banking institutions by foreign banking interests require specific application to and approval by, the Treasury Board. The phrase "direct or indirect" should be broadly interpreted to cover investments by foreign banks or any associated company, directors or officers. Any banking shares beneficially acquired directly or indirectly in knowing contravention of this provision could be made subject to forfeiture to the Minister of Finance. The relevant stock certificates could be cancelled, and stock exchanges and transfer agents notified. New certificates could be issued to the Minister, who should be required to dispose of the shares in the market in an orderly way within a reasonable period of time, the proceeds less expenses and any penalties specified in the legislation being returned to the foreign bank. In cases where this prohibition was unwittingly contravened by foreign banking interests without Treasury Board approval, they should be required to dispose of the shares on Canadian stock markets within a reasonable period of time. In the event that this recommendation is accepted, the prohibition should have effect from the date of publication of this report.

We prefer this direct approach to the question of bank ownership—foreign or domestic—to other devices which might be used, such as cancelling the voting rights of shares in excess of stated proportions in the hands of non-resident banks or imposing a general limit on the size of individual bank stock holdings.

On balance, we do not think this requirement of Treasury Board approval should apply to existing foreign bank holders of such shares. However, the existing holdings of any individual foreign bank should not be increased, unless permission is granted by Treasury Board.

CONCLUSION

Our basic view of the changes needed in Canada's banking legislation can be summarized quite simply. First, the safety of the public's funds and the responsiveness of the institutions to monetary measures is not promoted by the imposition of extensive asset ratios or prohibitions on banks and their competitors. Provisions of the former type therefore need not be added to the present soundly-conceived Bank Act, while some of its present investment prohibitions should be removed. Secondly, the institutions not presently regulated by the Bank Act have moved increasingly into the banking field while the banks have simultaneously moved into theirs. The result is that the present network of divided regulation over institutions has become unduly arbitrary, inequitable and—in some cases—inadequate. For these reasons, we recommend that the Bank Act apply to a wider group of deposit-taking institutions and that those not covered by the Act be explicitly prohibited from engaging in banking. Finally, we believe that a system in which all similar institutions can compete equally with a minimum of legislative specialization will best serve the needs of the public while retaining the essential ability to adapt to changing needs and circumstances. We have therefore recommended the continuance of certain features of the present Act, and the introduction of others, with a view to ensuring that competition is not blunted by price agreements or the uncontrolled acquisition of competing institutions by their rivals.

In line with this position, we recommend that the powers of banking institutions be broader than any of them exercises under present legislation. They should all be free to invest in N.H.A. or conventional mortgages, subject in their conventional lending to the 75% loan to value limit recommended in Chapter 14. Similarly, they should all be free to make commercial and personal loans without restriction on the security they choose to take, and should all be entitled to the classes of security now available to chartered banks under Section 88 and related parts of the Bank Act, and to any loan guarantees which are offered by the government to the present chartered banks. Other institutions need the same access to security as chartered banks if they are to compete effectively in this area, particularly as the banks' long experience and established position will give them a great working advantage.

Lastly, the ceiling on bank interest rates should be removed but these institutions and all others making small personal loans should be subject to extended and improved uniform ceilings on their charges for this sort of business.

Although the banking institutions will be under uniform legislation, we envisage that the practical effect of these changes will be to create an increased and desirable diversity of activity among them. We have already noted that this has occurred in some areas, and a wider banking community and increased competition should stimulate the process among the present chartered banks and encourage local and specialized institutions to apply for banking powers. In short, we believe that a modified and extended framework of legislation which allows competitive forces to be fully effective under a suitable and equitable pattern of government regulation will remove some of the inadequacies and rigidities which time and changing circumstances have created in the present basically-sound Bank Act. Additional changes will no doubt be necessary with experience, but we have tried to design our proposals to encourage creative future development by the system itself and to stimulate the provision of improved banking services to the public.

CHAPTER 19

THE SUPERVISION AND REGULATION OF BANKING INSTITUTIONS

We have described the spirit of competitive freedom which we believe should underlie the Bank Act and the changes necessary to give it effect. We turn now to definition of the institutions to which the Act should apply, and to our recommendations about the provisions which the legislation should contain to safeguard the public's funds and the integrity of the Canadian banking system, and to ensure adequate response to monetary measures and appropriate contacts with the central bank.

As already mentioned, the definition of banking institutions is bound to be somewhat arbitrary. Unfortunately, it is unavoidable if one is to legislate for them: even the re-enactment of present laws would continue to set ten institutions coming under the federal power to regulate banking apart from all the others operating under quite different federal or provincial legislation. We have considered the various possible approaches and have concluded that the most meaningful distinction—and the one best supported by such rather unsatisfactory precedents as exist—rests on the character of each institution's liabilities. Whatever else it may embrace, the banking function is generally taken to include the issuing of claims which serve as means of payment or as close substitutes for such money claims. It is because banks issue such claims, which—as we have seen in Chapter 6—have a particularly strong influence on financial conditions and economic activity, that national governments in Canada and elsewhere are granted jurisdiction over them.

It is worth emphasizing that, so far as we are aware, no legislative distinction exists between banks and others because they each make particular kinds of investments. Earlier banking theory did hold that since a bank's funds come predominantly from the issue of short-term claims, they should be invested principally in "self-liquidating" short-term loans. An institution borrowing heavily on a demand basis must pay close attention to the liquidity of its asset portfolio, but the narrow, dogmatic view has been discarded and our chartered banks have for decades safely invested in a broad range of assets, including private and government securities and longer-term loans and—more recently—in insured mortgages. Although the chartered banks have a higher proportion of business loans and securities than most other institutions, they have been moving into longer-term lending and it would be difficult to draw a clear distinction between them and others based on assets alone.

It is true that trust and loan companies may not now make ordinary and personal loans, but their money market, security and mortgage investments are often close substitutes for such loans and are similar in any event to a large part of the assets of chartered and savings banks. Similarly, the sales finance companies—like the banks—now hold substantial cash and liquidity and engage extensively in personal and business lending. Moreover, there would be no logic in attempting to create a distinct category of banks by preventing other institutions from investing funds

borrowed largely on a term basis in short-term assets: to do so would be to invert the reasoning of the old "self-liquidating" theory of bank investment. In any case, the important point for present purposes is that distinctions related to the appropriate investment of funds by banks or other institutions must be drawn from the nature of their liabilities, not the other way around.

Thus in our view the federal banking legislation must cover all private financial institutions issuing banking liabilities: that is, claims which serve as means of payment or close substitutes for them. With certain exceptions to be noted below, it should cover those financial intermediaries issuing claims which may be transferred immediately or on short notice by cheques or on customers' orders. It should also include institutions offering other demand liabilities, since these non-transferable demand claims pose exactly the same considerations of asset management for the institutions and thus raise the same problems with respect to protecting the interests of the public. The institutions can readily make arrangements so that funds held in demand form may not only be withdrawn at any time but may be transferred on customers' orders in much the same way as funds in directly transferable accounts: no meaningful line between the two can therefore be drawn and administered.

Commercial and savings banks also accept substantial amounts of funds in other short-term accounts which are for all practical purposes very similar to the short-term notice accounts included above. In recognition of the basic unity of all such demand and short-term institutional borrowing from the public—and to avoid the disruption which would arise if institutions were tempted to resort to artificial stratagems—we would include among the banking liabilities all term deposits, whatever their formal name, and other claims on institutions maturing, or redeemable at a fixed price, within 100 days of the time of original issue or of the time at which notice of withdrawal is given by the customer. We select this admittedly arbitrary dividing line, which will embrace three-month claims with a margin to spare, because to draw it closer to the pure demand claims would be unrealistic in view of the very close similarity of the various short-term claims. Although a reasonable definition of banking and savings banking would equally well allow the line to be set beyond 100 days, we do not believe that the definition need be extended in order to achieve an equitable, sound and uniform pattern of banking regulation.

Having drawn the definition broadly, a number of exceptions should be made in order to exclude financial institutions which need not be regulated by the federal authorities. (The banking authorities need not concern themselves with the incidental deposit borrowing and short-term lending of non-financial firms such as some retail stores which hold funds on account for their customers.) First, we would exclude provincial government agencies accepting deposits because their soundness is assured by their parent governments; however, major steps to extend the activities of such agencies or to establish new ones might raise an issue for the federal authorities and lead to subsequent review of this recommendation. Secondly, we would exclude deposit-taking institutions dealing with less than 50 people. Those who supply funds on a private or semi-private basis to the very small financial institutions, whether they specialize in mortgage investment, sales financing or some other kind of business, presumably know the circumstances well, are willing to accept whatever risk there may be and do not need the sort of protection which should be provided to people investing in the liabilities of larger, more impersonal enterprises. However, provision should be incorporated in the legislation to bring such institutions under control if there is evidence that they are in fact obtaining funds from a broader public.

The banking legislation should also exempt institutions which do borrow from a broad public but whose only short-term liabilities are in the form of marketable paper not redeemable on demand or short notice and which sell these liabilities through independent dealers or other agencies subject to the prospectus and other re-

quirements of the securities acts. Such liabilities are similar to those of other companies raising funds in the central securities markets, and the public interest can be safeguarded in such instances by appropriate securities legislation. In order to ensure that no regulatory gaps arise, the securities legislation should require such companies to register all their issues, irrespective of term. Similarly, investment dealers and stockbrokers holding customers' funds or borrowing from others at short-term should not be made subject to the banking legislation since they can be adequately regulated by securities administrations and the self-governing bodies and since their "banking" activities are only incidental to their main functions. In order to ensure that others are not brought unnecessarily under the banking legislation, the Treasury Board should have the power to make other exceptions. However, it should be emphasized that where an institution does come under the banking legislation, all of its intermediary activities—not simply those relating to the issue of the "banking liabilities" defined above—will be subject to regulation by the banking authorities.

We believe that this definition of banks based on the essential banking function realistically reflects the character of our financial system and can be made the basis of uniform, equitable banking legislation. In addition to the present chartered and savings banks, it embraces many trust and loan companies, some other deposit-taking institutions and the caisses populaires and credit unions. We have already noted the special case for leaving regulation of the local caisses and credit unions to the provincial authorities, subject to certain conditions recommended in Chapter 9, but we believe that the central societies should be integrated into the national banking system in order to bring the movement under the common monetary regulation, to encourage its continuing contact with the national authorities and to ensure that sound liquidity standards will be maintained throughout the system. Sales finance companies and others issuing demand liabilities or those redeemable at short notice would also come within the purview of the Act, unless they chose to confine their short-term liabilities to marketable paper subject to genuine notice requirements.

We have emphasized in the previous chapter that there will continue to be very real differences in the business done by those institutions which will have common powers, and indeed that we expect the legislation to stimulate diversity. Some institutions will thus continue to do a substantial current account and commercial loan business, others may emphasize personal and business lending although financing these activities largely through term deposits, while still others will tend to concentrate on the attraction of term deposit funds for investment in mortgages and securities. In order to avoid creating the false impression that the new legislation had suddenly removed all differences in the particular types of banking business done by the different institutions, we recommend that only the present chartered banks and others incorporated in the same way by Act of Parliament should be entitled to use the name "bank" without qualification. The two savings banks could continue to use the term "savings bank" if they wished, while other institutions licensed under the banking legislation—some of which would be federal corporations and some provincial—should be required to qualify the word bank in their names by the use of other words indicating the character or background of their business. The caisse populaire and credit union centrals would of course be free to retain their present names although they might add the word bank if they wished.[1] Such distinctions would serve to differentiate, say, a sales finance company doing a relatively small banking business in connection with its main activities from an institution dealing more widely in banking liabilities.

Whatever distinctions one may wish to draw within the group of banking institutions, they must nevertheless all have the same borrowing

[1] Central societies may wish to re-incorporate federally. If so, special legislation would have to be drafted so that they could retain their cooperative structure in matters such as share capital, voting rights and management committees.

and lending powers. If one tried to set up a scale of broadening powers to be granted institutions as they developed, one would first of all have to grant the "senior" institutions all the powers possessed by any others: otherwise the developing institutions would be in the impossible position of having to drop a substantial part of their business in order to qualify for "promotion". To be specific, if the chartered banks did not have full mortgage powers and were subject to a restrictive interest rate ceiling, no trust or loan company would ever be able to take on chartered bank status.[2] Taking the other side of the question it is difficult to see what powers enjoyed by the chartered banks can logically be denied to other banking institutions. While there is some justification in the view that institutions which borrow short should not lend an excessive share of their funds at long-term, there is no logic in the reverse proposition. Thus, there is no logic either in prohibiting trust companies and loan companies from making business and personal loans not fully secured by bonds or stocks or in limiting the savings banks' powers in this direction.

It is entirely possible that some trust and loan companies will choose not to take up banking powers and will thus not come under the common legislation. Provincial companies in this position would continue to operate under provincial legislation and supervision, suitably modified to take account of the new federal legislation, and—we hope—to minimize any restrictive asset ratios which serve no purpose in protecting the public. Comparable federal companies not wishing banking powers might choose to reincorporate provincially, but it would probably prove necessary to maintain federal legislation as well. Non-banking trust and loan companies coming under it should be supervised by the Inspector General of Banks rather than the Department of Insurance, since their functions are closer to those of the banking institutions under the Inspector General's regulation. In any event, all companies which wish to obtain banking powers, including the sales finance as well as the trust and loan companies, would be free to apply to Treasury Board. If they met the requirements, they would be chartered or licensed as banking institutions, but if they did not they would have to withdraw from any banking functions in which they are presently engaged.

Having thus explained the basis of our recommendations, we come to the main provisions which the banking legislation should contain. In most essentials it should be based on the present Bank Act, which has evolved through generations of banking experience. It will be seen that most of our recommendations simply carry forward the careful development of Canada's banking law in already established paths and apply its provisions more generally to the institutions now doing a banking business.

SUPERVISION AND INSPECTION

The essential feature of banking regulation must be good and thorough supervision and inspection such as that which now takes place within the framework of the Bank Act and contributes so much to the soundness of our chartered and savings banks. We have found considerable variety in the quality of supervision of other institutions across the country, and think it essential to act before there is a repetition of the unfortunate experiences of many chartered banks prior to the establishment of good supervision in the 1920's. It is also essential to make this supervision as flexible and free of rigid rules and regulations as possible in order to avoid inducing an unnecessarily conservative approach by our financial institutions to the conduct of their business.

The main job of the government authority must be to stimulate the financial institutions to create their own internal regulation. The authorities should rely heavily on such self-regulation and on the shareholders' or members' audit once satisfactory standards have been developed; such an approach is both more effective and more eco-

[2] While we have recommended that the chartered banks should not be allowed to apply for trustee powers immediately, we have stressed that this provision should not oblige the present trust companies to discontinue the trustee business when a banking license is obtained. If they wished to apply for a bank charter, the position of the present chartered banks should in equity be reconsidered.

nomical than building up a large and costly staff which would unnecessarily duplicate work already done. To this end, we recommend that the federal authority have power to require regular returns from the institutions under its jurisdiction (as is now the case for the chartered banks and Quebec Savings Banks) and to require that all such institutions maintain adequate internal inspection procedures and be subject to regular outside audit. The auditors should be chosen from a panel of highly qualified auditors approved by the authorities (as in the present Bank and Savings Bank Acts) to avoid any repetition of the hopelessly incompetent auditing procedures which led to the last chartered bank failure in Canada forty years ago. In addition, the federal authorities should have power, as they now do under the Bank Act, to enlarge the outside audit and to require such additional returns as may be necessary to satisfy them that the creditors' and shareholders' position is safe and that the institution is in sound financial condition.

The authorities should have the additional power, now lacking in the Bank Act, to require institutions to take such steps as may be deemed necessary to achieve these aims. Such power should be used only with the express consent of the Minister and should be subject to appeal to the Treasury Board or some other appropriate body. It should be used only sparingly and when attempts to persuade the institution concerned to modify unsound practices have failed. We do not believe that any weakness serious enough to justify the use of such powers should be left for cure merely to the channels of publicity, particularly if a number of institutions are involved, since a prolonged public correspondence might not be concluded before the institutions concerned had become insolvent.

There is no doubt that if the Inspector General discovered such a situation it would not be allowed to go unchecked, despite the lack of formal power to take action, but we nevertheless think explicit provision for dealing with such situations ought to be made in the Act. It is of course vital to phrase this recommended authority in such a way as to leave no doubt whatever that it relates only to the solvency and soundness of financial institutions. Its use should be accompanied by a formal statement from the supervising authority that it was being invoked for no other purpose, in order to ensure that it does not become a means for the government to direct financial institutions as to the types or amounts of assets that they must hold for reasons unrelated to the soundness of the institutions.

The staff of the Inspector General of Banks would have to be enlarged to undertake these new responsibilities. The cost of supervision should continue to be assessed on the institutions in proportion to their size, or perhaps on the basis of some more equitable measure of the expenses incurred by the supervisor's office. We have considered whether it would be advisable to replace the position of Inspector General by an inspection board of perhaps three officials to provide a more balanced approach to regulation than it might be possible for one man to take. The enlarged staff which will be necessary would doubtless include individuals with particular knowledge and working responsibility for particular groups of institutions—such as the caisses populaires and credit union centrals. Moreover, there are advantages in focussing final authority under the Minister in one individual. The consequences of appointing one or two inadequately qualified men to the board and the danger that institutions would try to play one off against the others might prove serious. Finally, it might be difficult to continue attracting men of the high calibre needed if they were to share responsibility and authority with others. For these reasons we prefer the present arrangement.

The present difficulty mentioned to us by the Inspector General of training successors to the office could be met readily in an enlarged staff by careful selection of personnel. This would overcome a problem which has led to suggestions that the Inspector should be an official of the Bank of Canada where arrangements for training and succession could easily be made. In any case, the Inspector General can do his job best as an independent official not having other interests or responsibilities which may conflict

with his work. For instance, it is easy to imagine circumstances in which the central bank and the Inspector General might have different views about the need for regulation of bank liquidity. Moreover, this change in the location of the office would deprive the Minister of a valued advisor thoroughly familiar with banking matters.

We believe that the present provisions relating to the Inspector General's tenure of office are appropriate. They provide that he holds office during good behaviour, but may be removed from office by the Cabinet for misbehaviour, incapacity or failure to perform his duties properly; he is also outside the provisions of the Civil Service Act although an officer of the Department of Finance. These provisions ensure the independence and freedom from short-run political pressures so essential in this important job.

Competent supervision can provide the public with a large measure of protection in its dealings with financial institutions, although there should, as now, be no warranty that federal inspection would protect depositors or shareholders against losses. Given such regulation, we do not see the need for imposing a general system of deposit insurance, especially as none of the institutions thought it desirable. Responsible elements in the credit union movement have, however, established mutual insurance schemes for the locals, and we have supported this approach by recommending that all such societies belong to a mutual aid fund in order to provide insurance against the risks of their relatively undiversified local business.

THE REGULATION OF SMALL LOAN CHARGES

At present the small loan companies and licensed moneylenders are regulated by the Superintendent of Insurance under the Small Loans Act, which sets limits on the charges they may levy for cash loans. As noted in the previous chapter, we believe that all cash lenders—including the banking institutions—should be subject to uniform regulation, and we think it appropriate that supervision of the amended legislation be transferred to the Inspector General of Banks. This would leave the Superintendent of Insurance free to concentrate on supervision of the insurance companies and on the presently almost unregulated area of pension funds, a task which involves special actuarial skills.

Although we are not familiar enough with all the details of the small loans business to prescribe the exact provisions of the law, it would be desirable to raise the maximum size of regulated loans from the $1,500 now in the Small Loans Act to at least $5,000 in view of the substantial amount of individual borrowing which is now above the regulated limit. The present maximum charges of 2% per month on the first $300 and 1% on balances between $300 and $1,000 are not unreasonable, but the ½ of 1% per month allowed on balances over $1,000 is too low and simply prevents most companies from lending amounts between $1,000 and $1,500. A maximum of 1% on all balances from $300 to $5,000 might be more appropriate.[3]

There are strong arguments for applying the law to all credit transactions, whether cash loans or sales finance credit, but we have not made a thorough study of all the difficulties of doing so and are therefore not prepared to make such a recommendation. However, we do recommend that it be mandatory to disclose the terms of conditional sales as well as cash loan transactions to the customer. In addition to indicating the dollar amount of loan or finance charges, the credit grantor should be required to express them in terms of the effective rate of charge per year in order that customers may compare the terms of different offers without difficulty.[4] Different

[3] The law should also contain features designed to prevent extortionate charges by the writing of several small contracts for under $300 rather than for one larger sum to which the lower rate would apply. It should also retain the time feature of the present Small Loans Act which provides for somewhat lower rates on longer-term contracts which are cheaper to administer.

[4] On small contracts the administrative costs are high relative to the amount of credit and inevitably involve high annual rates. It might be advisable to allow a flat amount service charge of, say, $1.00 per contract and to exclude this portion of the charge from the amount required to be expressed in annual rate form. If this is not feasible, the main purpose of the legislation could be achieved by exempting all amounts under $50 from its provisions, while preventing evasion through the writing of numerous small contracts below the exemption limit.

methods of calculation yield slightly different results, but there is no reason why disclosure in terms of the effective rate of charges cannot be made according to an agreed formula, and some lenders already do so:[5] comparability is more important than the precise level. While we recognize that there is great difficulty in calculating the exact charge if use is made of a revolving credit, there is no reason why the customer cannot be shown the effective charge if he follows a typical plan. Borrowers may indeed be more interested in the dollar amounts of the finance charges and monthly payments than in the effective interest rate, but it will certainly not do any harm—and may well do much good—to let them know the effective rate as well. The distribution of approved rate books by the grantors of credit would minimize any difficulties of calculation from their point of view.

Nor are we impressed with the argument that requiring disclosure would raise the cash price of an article, and thus lead to concealment of the effective interest rate. We believe that, as now, effective competition will keep the cash price at realistic levels, but in order to protect against the possibility of merchants using inflated cash prices for the purpose of calculating interest, the Act should contain a provision that the price of the article must be that at which cash transactions are normally carried out. Finally, this legislation should impose stiff penalties for excessive charges or failure to disclose. At the least, the lender should forfeit all principal and interest on the illegal transactions. In addition, fines should be imposed and, as now, the authorities should have the power to suspend the licenses of lending institutions in cases of flagrant violation.

BANK CAPITAL

A number of recommendations relating to bank capital were made in Chapter 7. It was recommended that the restrictions governing the par value of bank stock and the price at which new stock may be issued should be removed. However, we recommended that the rule requiring that new stock be issued pro rata to shareholders be retained.[6] In addition, we believe that the general prohibition against lending on the security of bank stock should be retained since the principle of a bank lending against its own equity is unsound. Moreover, unrestricted lending against the equity of other banking institutions could lead to difficulties and to conflicts with the ownership recommendations made in the previous chapter: we would not, however, object to exceptions being made which enable banking institutions to lend against such collateral to individuals in moderate amounts.

We have carefully considered the arguments for requiring banking institutions to keep a minimum equity capital base in relation either to the total of their deposits and other liabilities or to the total risk assets in the portfolio. Whether or not it is required by law, every sound institution must maintain adequate capital and reserves in order to protect its creditors against the losses which may be suffered on investments. Moreover, it is important that capital be large enough to ensure that the shareholders have a lively interest in the sound management of their company. We have, however, come to the conclusion that there is no formula which can take into account all the factors which are relevant to a judgment about capital adequacy. These include: the age and size of the institution and the experience of its management; the term, riskiness and diversification of its assets, including the nature of the collateral held against loans; any indirect or contingent liabilities it may have incurred, including those arising out of trustee business; its investment in fixed assets and its commitments under lease arrangements for office and other facilities.

Thus, other things being equal, a new, small institution needs relatively more capital than a medium sized one, which in turn needs to maintain

[5] See, for example, *1963 Annual Report of Coronation Credit Corporation Limited.*

[6] Subject to limitations on the stock-holdings of foreign banks or others arising out of the recommendations put forward in Chapter 18, and to the present exception that shares need not be offered to residents of countries which would require disclosure of information not revealed under Canadian laws.

a higher capital ratio than a large long-established institution. An institution making risky loans to one industry in one location obviously requires more capital than one dealing in relatively riskless assets or with a wider geographical and industrial spread to its activities. The same type of loan may be less risky to one institution than to another, perhaps because the client and his reputation are well-known to that institution, because the type of formal security taken differs slightly, because the institution has special ability to handle such loans, or because the contract provides for faster repayment. An institution which can resort to supplementary pools of capital such as a mutual aid fund may need less equity on its own balance sheet than one which has no such privileges. Institutions with heavy investment in specialized real estate and premises and other fixed assets or with burdensome lease commitments require more capital than those in a different position. Finally, an appropriate ratio of capital to assets in one set of economic circumstances may be quite inappropriate in another, for example if the national or local economy undergoes some structural change. A formula which requires enough capital to meet all possible contingencies at all times may be unnecessarily burdensome, but a lower requirement may be inadequate for some institutions.

In practice, the capital to assets ratio varies widely among institutions, as can be seen from Table 19-1. During the post-war period, the capital positions of savings banks, trust and loan companies have declined as a proportion of their total and risk assets in consequence of the adjustment from heavy investment in government securities during the war and the relaxation of lending restrictions on the savings banks and the capital requirement for the trust and loan companies. The chartered banks began to raise new capital on a substantial scale following the Bank Act revision in 1954 which allowed them to do so without offering shares to non-resident shareholders; this would have subjected them to foreign requirements regarding disclosure of their inner reserve positions, executive salaries and other matters not made public in Canada. Prior to that time, the banks had allowed their capital to run below the levels they wished to maintain.

The caisses populaires and credit unions and the finance companies have also tended to increase their capital in relation to their assets. These differing trends have brought the capital positions of different institutions closer together than they were, but there are still wide disparities. A similar pattern is shown by comparisons of the ratio of capital to riskier assets, no matter where the line is drawn between "risk" assets and others such as cash and federal government securities. Statistics alone do not fully reveal the true position of an institution: for example, the risk of credit union lending is substantially reduced by their special knowledge of their customers and by the social pressure which a co-operative

TABLE 19–1

CAPITAL AND RESERVES AS A PERCENT OF TOTAL ASSETS[a]

	Chartered Banks	Quebec Savings Banks	Trust Companies	Mortgage Loan Companies	Caisses Populaires[b]	Credit Unions[b]	Sales Finance Companies
1946	5%	12%	24%	27%	n.a.	n.a.	n.a.
1954	6	9	15	17	5	3	13
1961	6	8	10	15	5	4	14

[a]Specific reserves are excluded.

[b]Equity includes rest account but not undistributed earnings. Most of the latter are due to be distributed to shareholders shortly after the year-end and are not part of the societies' permanent capital.

organization can exert on those who fail to repay. We have not tried to make a detailed comparison with the position in other countries, but figures supplied to us by the Canadian Bankers' Association confirm that similar variations are apparent in other countries; a table showing the capital to deposit ratio of the world's twenty largest banks indicated there was a range of from just over 4% in the case of an English bank to as much as 14% in the case of an American institution.[7]

We conclude, therefore, that the legislation regulating financial institutions should not establish statutory ratios of capital to assets. It should set a relatively low statutory minimum for starting up a banking institution so as not to discourage the entry of smaller specialized companies, but at the same time it should give the Inspector General power—subject to appeal to the Treasury Board—to set such higher requirements as may be necessary to ensure the soundness of enterprises with more ambitious plans, and in particular to absorb the likely expenses of establishment and early operations. This, we understand, is the actual position under the Bank Act at the moment. The present Bank Act requirement that a new bank have paid up capital of at least $500,000 as a minimum legal requirement seems appropriate. Other qualifications for a charter or incorporation should be kept to a minimum, although we feel the Act should require that applicants be of sound reputation and proven business experience.

Once institutions are operating, the Inspector General should have power to require that adequate unimpaired capital be maintained to ensure that the business is run on sound lines. While avoiding rigid rules, the Inspector General would doubtless develop guide-lines that take into account the loss experience of the institution concerned, general economic conditions in the area where business was done, the practices of soundly-managed institutions and the various factors mentioned above when reviewing the ratios of individual institutions.

[7] CBA Submission, Table VIII, page 148.

One way in which the capital soundness of an institution can be seriously compromised is by the making of excessively large individual loans or investments. We therefore recommend that all loans or investments in excess of 5% of capital and reserves should be reported to the Inspector General.[8] The banks should not advance or commit in any form more than a reasonable amount in relation to capital and reserves to a single borrower (other than the federal and provincial governments and similar foreign governments). The Inspector General should continue to see that prudent lending practices are followed. The present provision of the Bank Act which precludes individual directors from participating in decisions about credits to them or to enterprises with which they are associated should be retained, as should the requirement that such credits in excess of 5% of the bank's capital be approved by two-thirds of the other directors present. In addition, copies of the relevant statements regarding directors' interests and details of the individual loans or other credits involved should be forwarded to the Inspector General;[9] similar disclosure arrangements might be made with respect to the total of salaries and bonuses paid to officers and directors.

The Inspector General would thus be put in a position to notice any undesirable trends and should be given the power to require each institution to publish the amounts involved in its annual return to shareholders or more frequently if deemed necessary. In addition, he would of course have the overriding power to require any institution to desist from making any loans to

[8] Under the existing rules, which should be retained, the Minister also receives copies of the auditors' reports on loans in excess of 1% of paid-up capital and reserves on which losses are considered likely to occur. In addition, the Inspector General—under his general authority to call for information from the banks—obtains reports on all loans in excess of a certain limit set for each bank, and should continue to call for such additional returns if he considers it necessary.

[9] At present, banks are required to annex the "aggregate amount of loans to directors and firms of which they are members, and loans for which they are guarantors" to their monthly balance sheet returns under Schedule M.

directors or others if these seemed likely to imperil the soundness of the institution concerned.

INNER RESERVES

The present chartered banks, like other financial institutions and non-financial companies, may set up specific reserves out of pre-tax earnings to write down the value of particular assets to their estimated realizable value; as with other taxpayers, subsequent recoveries in excess of the written-down value of the accounts concerned must be taken into taxable income. The banks, however, may also set up contingency reserves out of pre-tax income to meet unforeseen future losses, the total of these two types of reserve being subject to a limit set by the Minister of Finance.[10] Both the specific and contingency reserves are disclosed to the Inspector General of Banks but are secret in the sense that they are not disclosed to the public or the shareholders. In addition, the chartered banks—and other taxpayers—are not prevented by tax laws from setting up undisclosed reserves from their after-tax income, but the total amount of income tax paid each year must be disclosed.

From the time when rules for the banks' inner reserves were first drawn up in 1944 until 1954, the Minister of Finance allowed whatever specific reserves a bank might reasonably claim plus contingency reserves of up to 2% of Government of Canada, U.S. and U.K. issues issued for a term of one year or more, 3% of provincial securities and 5% of other investments, of loans[11] and letters of credit and of long foreign exchange positions. The rules were changed in 1955 to apply the percentage limits to the sum of specific and contingency reserves and in 1957 to disallow reserves on Government of Canada and provincial securities which were to be valued on an amortized basis; annual changes in these values, and trading profits or losses, must now be taken directly into income.

In 1960, the fixed percentages were replaced by a single variable percentage which changes each year in proportion to changes in all banks' average loss experience over the preceding 25 years. The original base for this calculation was set at 24 times the average 25 year loss experience, which gave a ratio of 4.944% in 1959 —close enough to the previous 5% limit to give continuity. Since then, the ratio has declined because the loss experience of recent years has been low relative to that of the earlier years being dropped from the calculation each year: the maximum permitted ratio in 1963 was 3.504% of reservable assets. If the ratio of specific reserves claimed remained unchanged from 1962, the maximum permitted general contingency reserves in 1963 would have been about 2.8%.

There are two major issues to be considered—the extent, if any, to which the right to accumulate untaxed contingency reserves should be granted to banking institutions and the question of the secrecy of reserves. The arguments and precedents in Canada and elsewhere are not conclusive; we have considered all sides of the question carefully and have reached a view, but one which we recognize is a matter of judgment.

There is no question about specific reserve appropriations for probable losses: it is universally recognized as prudent business practice to provide in a reasonable way for such probable future losses and the tax authorities allow such provisions to be deducted from taxable income.

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[10] All mortgage lenders, including the trust and loan companies, are entitled under Section 85G of the Income Tax Act to set aside pre-tax income of ¼ of 1% of their conventional mortgage portfolio annually to build up a published contingency reserve to a limit of 3% of the portfolio. This provision, and that for the banks, are the only statutory exceptions to the general rule that taxpayers may not set up contingency reserves. However, some features of the regulations respecting the capital cost allowances which can be deducted from taxable income may provide incentives to both financial and non-financial businesses to invest in fixed assets and may thus in some respects be regarded as akin to the incentives provided by bank contingency reserves; the analogy, though, is not one which we would be inclined to push too far.

[11] Other than those to or guaranteed by the Canadian, U.S., and U.K. governments, those secured by Government of Canada bonds being purchased on instalment plans and those to or guaranteed by other banks.

It is the question of untaxed contingency reserves which is contentious: those who argue that they are necessary point to their existence in the United States, to the additional inducement which they give to banks to put aside what amounts to additional capital in good times when they might otherwise be less concerned about their capital ratios, and to the effect which they may have in encouraging bank managements to be more venturesome in their lending policy. Those opposed to untaxed contingency reserves point to the English banks (which must pay taxes on their general reserves), claim that good management and supervision will ensure the adequacy of capital and argue that the venturesome lending policies of financial institutions without untaxed contingency reserves indicate that they are not required.

We recognize that this is a matter in which no absolute assertions can be made, but we are of the opinion that the existence of such reserves has contributed to the soundness of the Canadian banking system. We recommend therefore that the right to accumulate such reserves be continued and, of course, extended to all banking institutions. The extent to which they should be allowed to accumulate free of tax should, of course, be limited. The advantage to the institutions lies in the use of the funds that would otherwise have been paid in taxes. Thus, if contingency reserves are taken for illustrative purposes as being $300 million, the banks have the use of $150 million that would otherwise have gone to the tax authorities (assuming a 50% corporation income tax). If they earned something over 5% on these funds before taxes, their pre-tax earnings are increased by $8 million and their after-tax profits are increased by half as much. These figures may be compared to the banks' pre-tax earnings of $189 million, dividends of $60 million, and capital of almost $1.1 billion in 1962. While some have suggested that these extra earnings benefit the depositors and borrowers, the most direct benefit would appear to be to the shareholders.

The present allowable level of untaxed contingency reserves seems adequate to meet extraordinary losses over a period of years. However, post-war loss experience has been low and may well be misleading, and a formula which is based on it may reduce the maximum ratio to unsatisfactory levels. As a result of the changes in the rules and the recent low levels of bank losses, the ratio of reserves to bank loans and municipal and corporate securities has been just about halved over the past decade. In our judgment it would be wise to bring a halt to this process and we therefore recommend the establishment of a fixed ratio for the maximum of tax-free reserves. The level at which this ratio should be set admittedly involves an arbitrary decision. In the United Kingdom where reserves are taxed, there is no limit, while in the United States the limitation is based on a bank's loss ratio over any 20 consecutive years, starting not earlier than 1927. The maximum allowed is three times this annual average, which in practice we understand puts a lower ceiling on large U.S. banks than that aplying to the Canadian banks. However, the Saxon Committee, a committee of bankers appointed by the U.S. Comptroller of the Currency, recommended that the maximum be raised to a flat 5% for all banks.[12]

The loss experience of the Canadian banks is naturally relevant in determining the maximum permitted ratio of reserves. In the favourable years since 1950, bank losses on loans have averaged about $\frac{1}{8}$ of 1%, with the peak year being under $\frac{1}{3}$ of 1%. However, this experience gives no real guide as to what is appropriate for emergencies: it may be contrasted with a five year period in the 1930's when losses averaged over 1$\frac{1}{4}$% of loans. While such drastic circumstances seem unlikely to recur, it should also be remembered that bank earnings ratios before losses in those years were much higher than they are today.[13]

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[12] *National Banks and the Future*, The Report of the Advisory Committee on Banking to the Comptroller of the Currency, 1962.

[13] Earnings after taxes in those years exceeded losses by $72 million, but dividends were cut to 60% of their 1929 level and were only maintained at this level through drawing on inner reserves.

75319—26½

The choice of a ratio depends also on whether or not specific provisions are included in the restricted amount. The present Canadian practice of applying a single limit to the combined amount of specific and contingency reserves blurs the real distinction between losses foreseen on particular accounts and the general risks of the banking business. Moreover, it does not allow for differences among banks depending on their current loss experience. We do not favour the American system of setting each bank's maximum independently on the basis of its own earlier loss experience for this can lead to serious inequities as the composition of a bank's business and the quality of its management change through the years. On the other hand, some room for adjustment to a bank's particular circumstances is desirable and the removal of specific provisions from the restricted reserve category—as was formerly the practice in Canada—is the logical way of achieving this. We therefore recommend that this practice be restored and that general contingency reserves be limited to 3% of the assets eligible for reserves, a modest increase from the present level of about 2.8%.

The separation of specific from contingency reserves might pose problems for the tax authorities and the Inspector General, who would have to ensure that excessive specific provisions are not being taken. At present, some banks tend to make rather generous allocations to specifics since it makes little difference how the reserve appropriations are allocated within the combined maximum. The problem, however, also applies to all other taxpayers and should not be insurmountable. Wide swings in the market values of municipal and corporate bonds and in the banks' long foreign exchange positions might also confront the banks with the problem of switching reserves back and forth from the general to the specific category, but this also is a problem which can fairly readily be handled, assuming that the banks will not substantially vary their total reserve provision, except when business conditions or actual or potential loss experience change. If it is decided that these difficulties outweigh the advantages of treating specific provisions separately, the maximum applying to the combined reserves should be set at not less than 3¾%—that is 3% plus the present ratio of specific reserves—and perhaps at 4%. We mention the higher figure because of the desirability of ensuring that banks with above-average loss expectations have the flexibility to make adequate reserve provisions.

Like the question of contingency reserves itself, the issue of their secrecy has been much debated. In the United Kingdom, the Jenkins Committee in 1962 recommended by a vote of 9 to 5 that secrecy be maintained, while in the United States the Saxon Committee recommended full disclosure, a practice now followed in any event by many American banks. In Canada, enquiries by the House of Commons Banking and Commerce Committee in 1944 and 1954 concluded that publication of unexpected and exceptionally high losses in any one year might adversely affect confidence in a bank or even in the banking system as a whole. Thus, there are precedents and experience to support those who argue that secret inner reserves are necessary to reduce fluctuations in published profits, maintain public confidence, and encourage banking managers to take risks which they might be unwilling to assume if they had to disclose the occasional sharp loss which a more venturesome policy might entail. In support of this view, it is also argued that it is more difficult in any event to determine bank earnings than those of other companies since the result of current bad judgments may only become apparent much later.

On the other hand, the views of informed observers and the experience of other financial institutions in Canada and abroad could be cited just as easily to support the opposite viewpoint that rumours can be more dangerous than facts, that the public is well enough informed to accept occasional severe losses as a normal part of any banking business, that the shareholders are entitled to know how their company and its management are performing and, finally, that the discipline of public disclosure is good for management. It is our view that there is no compelling

case against disclosure, and we are satisfied to leave the matter in the hands of the authorities and the shareholders concerned. If a substantial body of shareholders were in favor of such disclosure—and to our knowledge none is—we do not believe it should be opposed by bank management. However, we believe that tax-paid reserves should in any event be incorporated in published shareholders' equity since there is no case for secrecy when inside reserves are in excess of the ratios deemed appropriate by the authorities. Good accounting practice calls for the disclosure of tax-paid reserves on balance sheets and there is no reason why banks or other financial institutions should be treated differently.

Regardless of how the question of disclosure of untaxed reserves is resolved, we do recommend that the loss experience, specific reserves, contingency reserves and tax-paid reserves of all banks combined should be published each year together with an accounting of the changes in reserve accounts. This will give some indication of trends in the business and may serve the useful purpose of destroying some myths about the size of reserves. If publication of individual bank figures is not undertaken, we also recommend that the Minister of Finance should work out appropriate rules to ensure that reserve allocations and drawings are not used to imply an earnings trend contrary to that which might reasonably be deduced by a person in possession of all the facts. If, for example, earnings are down substantially because of abnormal losses or any other factor, the banks should not be allowed to show an increase in published earnings or nominal declines in profits; the important consideration of depositor protection does not justify misleading the shareholder and the public.

Finally, in line with our own view that corporate disclosure generally should be improved, we recommend that bank profit and loss statements be made more informative: they should be required by legislation to provide shareholders with information about the sources of each bank's earnings and the nature of its expenses and other relevant information necessary for the shareholders to judge the performance of management. They might be similar in form to the present Schedule 'Q' to the Bank Act, though modified if appropriations to inner reserves were not to be disclosed. Moreover, we consider it anomalous that statutory auditors should not be called upon to certify the earnings statement of any financial institution while they do so for other businesses. We have not explored the problems involved in such certification with the accounting profession, but we suggest that the Inspector General of Banks and a committee drawn from the panel of approved bank auditors should study the matter and reach a conclusion as to the feasibility of such certification and the form it should take. This is particularly important in view of the fact that we have recommended the inclusion under the federal act of many financial institutions now subject to differing reporting and disclosure requirements.

Although the case for untaxed contingency reserves for banking institutions rests primarily on considerations of depositor protection, the authorities may wish to extend similar privileges to non-banking institutions such as those trust and loan companies that do no demand or short-term liability business. These companies, like the trust and loan companies which will come under the banking legislation, including its reserve provisions, are now entitled to build up from pre-tax income reserves equal to 3% of their conventional mortgage portfolios. We see no reason to alter this rule, although it might be desirable to adopt the banking regulations for these institutions as well. The rest funds of the central societies of credit unions and caisses populaires should be treated as tax-free contingency reserves subject to the general rules applicable to other banks: local credit unions and caisses, although not coming under the federal legislation, should also receive the same tax treatment.[14]

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[14] Those now holding rest funds in excess of the limits should be taxed on further increases, but not on any excess they may have carried at the time the legislation comes into force.

CASH RESERVES AND THE CLEARING SYSTEM

As pointed out earlier, every financial institution needs to hold some cash to meet the payment obligations which it may incur in the ordinary course of its business; these may result from withdrawals of cash or deposits by its customers, or purchases of assets by the institution itself. Clearly, any institution which did not keep sufficient cash—or liquid investments or lines of credit with other institutions which are readily convertible into cash—would be unable to meet its obligations and would sooner or later go out of business. In addition to these usual working balances, each institution must keep on hand, or have immediate access to, enough cash to meet any unexpectedly large payment drains. Thus, while only the chartered banks and Quebec Savings Banks are required by law to observe specified cash ratios, all other financial institutions dealing in short-term claims in fact hold comparable cash reserves to meet the needs of their particular business. Table 19-2 shows the actual cash ratios of selected groups of institutions.

Although any banking institution which wishes to remain in a sound condition must hold adequate cash, it is another question whether the regulatory authority should specify a minimum. In the case of capital ratios, we have recommended against the imposition of ratios, and it might be considered inconsistent to do otherwise for cash reserves. If sound management of the institutions and protection of the public were the only considerations, cash ratios in themselves would be of very limited usefulness. An institution can best meet its liquidity needs, whether arising from its having demand liabilities or from the maturing of notice and fixed term obligations, by carrying an appropriate share of readily marketable assets in addition to cash in its portfolio. However, cash requirements also have a place in the system of monetary control —not, perhaps, as crucial a place as some discussion would suggest, but an important one nonetheless.

All institutions are affected by changes in monetary policy regardless of the form and location of their cash reserves. Their experience over long periods and through the cycles of credit policy was described in some detail in earlier chapters which showed that their position depends on their success in competing for business and not directly on whether their reserves are held at the central bank or elsewhere or whether they are maintained at one level rather than another. These points were developed in Chapter 6 and in the appendix to it. Thus, the central bank's ability to influence institutional behaviour and credit conditions does not depend on the imposition of reserve requirements on all banking institutions since it can always take offsetting action to compensate for changes in credit flows arising out of changes in market preferences and institutional competitive positions. So long as the central bank has the ability to alter the terms on which its own liabilities—the ultimate cash in the system—are available and so long as the institutions are free to compete for funds on reasonably equal terms, their reactions to changes in the available supply of central bank cash will spread and reinforce the tightening or easing effect of the central bank's action discussed in Chapter 6.

However, the simple examples given in the earlier discussion also illustrated that the system's response is less certain and predictable if the main banking institutions do not work to known and stable minimum cash reserve positions. Otherwise, the institutions which lose cash may choose to live with lower reserves at least temporarily (or, in opposite circumstances, to hold more cash than usual) rather than make the adjustments in their asset holdings and rate policies which would immediately transmit the effects of monetary policy measures to other parts of the financial system. If the banking institutions do delay, the central bank would have to take further action in order to bring about the change in credit conditions it wishes to achieve. Markets might then react more violently than desired, with the result that large central bank transactions and irregular response by the insti-

tutions could create uncertainty, even confusion, in financial markets. A system of differing ratios, such as that discussed by the President of the Royal Bank of Canada, in which each bank would choose its own reserve ratio and notify the central bank of its decision, might work tolerably well, but the widely differing ratios and changes in them would needlessly complicate life for all concerned.

Absolute certainty of response can never be achieved—indeed it is important that the banking system be able to assist in absorbing temporary swings in the community's financial preferences—but the difficulties can be reduced if the banking institutions work to known reserve positions. In our system, as the Bank of Canada indicated, it would be sufficient if only the present chartered banks were included, for they bulk very large in the central securities markets and are a major factor in the competition among institutions. Nevertheless, we believe that equity among institutions having the same powers dictates that similar requirements should be imposed on all banking institutions so that all are required to hold the same amounts of non-earning assets relative to their different liabilities. Moreover, if the "outside" banking institutions become bigger and move more directly into short-term lending and money market activities, it might become increasingly difficult to maintain firm control over the whole financial system without subjecting them to specific cash ratios.

The existence of minimum requirements, while of itself of minor importance in guaranteeing an institution's solvency, will nevertheless give statutory effect to the working practices of the sounder institutions and improve the practices of others; it will thus contribute to the protection of the public. Finally, although the required cash cannot itself be used to meet liquidity needs (except to the extent that an averaging formula allows an institution to meet the daily ebb and flow of payments) the knowledge that a cash minimum must be observed should lead institutions to carry adequate liquidity to protect their positions. The recent report of the President's Committee on the financial institutions in the United States laid considerable stress on this role of required cash reserves and the increased power which they give to the supervising authority to insure that sound practices are followed in all aspects of the institutions' affairs.[15]

The actual choice of reserve ratios is bound to be somewhat arbitrary, although it would be difficult to devise a system more arbitrary than the present one. Ratios should not be set far above the level which a well managed institution would maintain in any event, and thus the imposition of new requirements should disrupt soundly established institutions as little as possible. However, the ratios must be set high enough to induce the main banking institutions to work as closely as is practical to them at all times.

There is a significant difference in the amount of cash which need be held against different types of liabilities: a ratio appropriate for purposes of protecting the public in the case of banks doing a substantial amount of volatile demand business would be unnecessarily high for those with few demand accounts and more term liabilities of various kinds. In order to meet this difference, we recommend that a higher ratio apply to liabilities which are transferable by cheque or on customers' orders or which are redeemable on demand or short notice at a set price, and a lower one apply to other banking liabilities issued with an original term of one year or less.[16] It will be recalled that in defining banking institutions we included all those issuing demand claims or liabilities maturing within 100 days which are not sold in securities markets through independent investment dealers or other agents. In setting reserve ratios, we move out to one year in order

[15] *Report of the Committee on Financial Institutions to the President of the United States,* Washington, 1963, esp. p. 17.

[16] "Short notice" might be taken to mean a minimum of 7 days. The distinction between under and over one year liabilities is made on the basis of terms at the time of original issue. If one specified remaining term to maturity, long-term liabilities would automatically be subjected to cash requirements as they approached maturity. It can be argued that since all short-term claims are similar, regardless of their original term, institutions should be required to hold reserves against all liabilities with less than one year to run. However, this would complicate matters, without contributing usefully either to the protection of institutional liquidity or to the efficacy of monetary control.

to avoid distortions which would result from attempts to avoid reserve requirements applying only to the shorter-term liabilities. Longer-term liabilities would not be subject to any specific reserve requirement, although needless to say an institution principally doing longer-term business would need to carry some cash for its normal business needs.

We believe it would be appropriate to set a ratio of 8% on demand or transferable liabilities and those redeemable on short-notice. On the other short-term deposits or comparable liabilities of the banking institutions, a ratio of 4% —that now in use in the United States for time deposits—would be adequate.[17] The higher interest which would have to be paid on deposits subject to genuine notice should eliminate any incentive to the institutions to bid for such deposits merely to minimize their cash ratios. However, if any institution tried to attract funds into the low ratio category with promises to waive the notice requirements, the authorities would have the power to apply the higher ratio to such liabilities.[18]

The present and proposed minimum ratios of cash holdings to reservable liabilities are given in Table 19-2. Based on these recent averages for each group of institutions, the chartered and savings banks and the caisses populaires will be required to hold less cash than at present, while the 1962 experience of loan companies was just about in line with the requirement. On the other hand, the average cash holdings of trust companies and credit unions tend to run below the requirements.

The small reduction in the requirement for chartered banks results from the fact that their corporate notice deposits would call for 4% reserves.[19] The present savings deposits which are in practice transferable on demand would require 8% reserves, but banks might reduce their cash holdings further by offering their customers a clear choice between chequable and term or notice accounts. Such reductions in the overall level of bank reserves are desirable since the present 8% is undoubtedly higher than the banks need keep.

Moreover, the possibility of holding a lower cash reserve against genuine term deposits and the absence of a statutory requirement on liabilities maturing in over one year may encourage the banks to consider new longer-term borrow-

TABLE 19–2

PRESENT CASH HOLDINGS AND PROPOSED MINIMUM REQUIREMENTS[a]

——	As a percentage of			
	Demand and short-term liabilities		Total Assets	
	Present Holdings	Proposed Requirements	Present Holdings	Proposed Requirements
Chartered Banks[b]	7.8%	7.7%	7.4%	7.3%
Quebec Savings Banks[b]	9.2	8.0	8.7	7.6
Trust Companies[b]	3.4	6.8	1.7	3.5
Loan Companies[b]	7.8	8.0	1.3	1.3
Caisses Populaires[c]	9.0	8.0	8.4	7.5
Credit Unions[c]	4.3	8.0	3.9	7.2

[a]Calculations are based on cash holdings and liabilities at the same dates and thus take no account of the use of a lagged deposit base: if institutions are growing, the amount of cash required will be lower than indicated. The proposed requirements are based on the current structure of each institutional category's liabilities.

[b]Average of 1962 quarter end data. In the case of trust and loan companies December is not included in the calculations because window dressing produces misleading balance sheet data. The amount of trust company certificates and term deposits maturing within a year has been estimated on the basis of the survey referred to in Chapter 10. It is assumed that all chartered bank "other notice" deposits had an original term of less than one year.

[c]1961 year end data on a consolidated basis for centrals and locals. Shares are included with deposits in calculating the first two columns.

[17] We stress that the reason for applying a higher ratio to volatile liabilities is not that the authorities need such a ratio for purposes of monetary control. Thus we see no purpose in relating cash ratios to the annual turnover of deposits as has been proposed in some quarters. (The turnover of current accounts is some 40 times that of savings accounts).

[18] Another possibility would be to relate the low cash requirements only to deposits which proved retroactively to have been immobile—presumably by calculations based on the amount of interest actually paid. This, however, seems unnecessarily complex and would involve the authorities in enquiring into the rate structure of each institution for the purpose of making the calculation.

[19] Some of these notice deposits have an original term of one year or more but the amounts are not known and all of them are therefore assumed to be for less than a year in the calculations of Table 19-2.

ing and lending markets. Although we do not favour the formal segregation of assets, the lower ratio will make the banks more aware of the natural division in their business which reflects the differing character of the funds employed.

The situations of individual trust companies differ widely, some having substantial demand and short-term liabilities and others raising a high proportion of their funds through longer-term liabilities against which central bank cash reserve requirements will not apply. Given the changing character of this industry's business and considerations of equity vis-a-vis the chartered banks, we do not consider the required shifting of under 2% of assets into cash to be excessive.

So far as the credit unions are concerned, we have already expressed our view that their cash holdings tend to be undesirably low: an increase of the magnitude indicated would thus not be harmful. In any case, the credit unions could lower the effective requirement substantially by enforcing notice regulations on withdrawals of share funds and deposits. The requirements for credit union and caisse populaire centrals should be based on the consolidated share and deposit liabilities of centrals and their affiliated local societies. However, there may be technical difficulties in applying the rules which would call for the formulation of special procedures having substantially the same effects as application of the general rules.

Our objective in this admittedly arbitrary matter has been to devise a system which protects the public and ensures responsiveness to monetary control but which is also simple, equitable and does not needlessly disrupt the institutions.[20] We believe that the principle of distinguishing between demand and short-term liabilities is sound and realistic. With the object of allowing some day-to-day flexibility and adjusting to the varying state of statistical reporting by different institutions, we also recommend that the requirement be based, as at present, on average liabilities in a recent period. The use of a known deposit base introduces certainty and—under a system with three ratios (8%, 4% and 0%)—would overcome difficulties arising from shifting of funds from one type of account to another. As we will argue in Chapter 22, the present lagged base does not lead to undue delays in the banks' response or allow the banks to escape the immediate effect of central bank action on their reserves. The question of giving the authorities the power to vary these ratios for monetary policy reasons will also be discussed in that chapter.

We believe that all banking institutions should be required to hold their reserves, other than till money, at the central bank. We do not make this recommendation primarily because the present position poses serious problems of monetary control—it does not—but because we believe this will help to foster improved contacts and working arrangements between the Bank of Canada and the institutions now holding their cash elsewhere. Moreover, we can think of no valid reason why some banking institutions should be required to hold reserves in one form and others not.

This will lead naturally to a desirable change in clearing arrangements. All banking institutions will be able to settle their clearings at the Bank of Canada rather than being required to make arrangements with one of the present chartered banks, although they could continue to do so if they wished. The Bank would thus have to equip itself to act as clearing agent for institutions at the centres where they are not represented, but there would be no need for it to take over the rest of the normal work of routing cheques and other payment items within the private financial system. The clauses of the Canadian Bankers' Association Act which give the Association the right of operating the clearing system should be repealed, and an association of all clearing institutions formed to manage the system and allocate costs equitably among all members in relation to the work done by each. The Bank of Canada as a member of the

[20] The Bank of Canada would have to cooperate with the banking institutions in facilitating the transition to the new reserve requirements, but this poses no great difficulty.

association would be paid a fair price for clearing work it undertook for any institution.[21]

We also recommend that there be a statutory prohibition on charges for the negotiation of out-of-town cheques, the actual handling of which does not involve any significant extra cost to the institutions concerned. This change would reduce the disabilities of those institutions not having an extensive network of branches across the country. It is possible, of course, that over the years the payments system may evolve more towards one of credit transfers similar to those in use in many European countries. Under this system, those with bills to pay go to their financial institution and instruct it to debit their account forthwith and to transfer credit to those individuals to whom they owe money. This system, under which every account in the country has a specified number, greatly reduces the paperwork of the financial system, cuts down on float and clearing charges, and ensures that the recipient gets the full amount owing to him. On the other hand, the present cheque system is extremely convenient for the payer and is so well and efficiently established in Canada that it is unlikely to be altered soon.

Regardless of whether these changes are made, it seems to us unreasonable that the chartered banks should have to negotiate all federal government cheques without charge to the authorities. It is true that the banks gain some advantage from government balances maintained with them in the ordinary course of events, although there is no guarantee of this and balances over $100 million are paid interest at a rate very close to that on treasury bills. The banks calculate that the net cost to them of handling government cheques is about $7 million a year, but the government argues that this is fair compensation for the privilege of extending charters to the banks. Nevertheless, we see no more reason for financial institutions to subsidize government than we see for the government to subsidize the institutions.

[21] Even if the central bank were gradually to assume a larger role in the mechanical job of clearing, and we see no advantage in its doing so, we find it hard to believe that this would enable it to pry into the affairs of individual banks and their customers, as suggested to us at our hearings. (Transcript, page 8256.) Even if the Bank actually wished to do so, the sheer physical job of vetting the millions of items passing through the clearings would preclude it, just as it presumably precludes chartered banks from detailed study of the business of other institutions which now clear through them.

LIQUID ASSET REQUIREMENTS

The cash which institutions are required to hold will enable them to meet moderate daily swings in settlements within the averaging period, but will not contribute beyond this to the liquidity of their assets. For their own protection and that of the public, the institutions must all have adequate liquid assets to meet more substantial day to day claims against them or to cover persisting withdrawals of funds. In addition to this crucial need for protective liquidity, a well managed institution will want a cushion of liquid assets to give it flexibility to take advantage of attractive lending opportunities when they arise. However, while all institutions must pay close attention to their liquidity positions, their needs differ substantially.

The most important factor influencing liquidity needs is the character of an institution's liabilities. Since demand deposits and similar claims may be withdrawn unexpectedly at any time, they call for greater liquidity in the structure of assets than true notice deposits, which in turn may be more subject to unexpected calls than fixed-term liabilities. Where there are formal notice provisions much depends on the actual practice adopted. If notice is in fact never required, an institution cannot suddenly impose it without exposing itself at the least to considerable ill-will and at worst to a collapse of confidence in its ability to meet its obligations which could set off a crisis in its affairs. (The credit unions, with their special relationships to their members and their tradition of self-help, have more room to manœuvre in this respect than the other institutions.)

On the other hand, an institution need not keep itself prepared to redeem all its demand liabilities at any time—indeed cannot do so if it is to fulfil a useful function as a financial intermediary. If a major run on a banking institution were to develop, the authorities and/or the other institutions have the means to supply the liquidity needed. If

the institution were also in danger of becoming insolvent because of poor investments, the authorities would, of course, also need to intervene to put its affairs on a sounder footing or to wind it up in an orderly manner. In the absence of some major crisis of this sort, however, an institution can normally count on the fact that a relatively small share of its demand obligations will be withdrawn regularly, the rate of withdrawal depending principally on the business habits of its customers and its own willingness to meet the competition from alternative investments. Large institutions operating over a wide area can usually count on a more regular pattern of settlements than smaller ones whose business can be more affected by individual transactions, while an institution with few large accounts relative to its total size is less exposed to sudden withdrawals than one having relatively more such accounts. Thus the need for liquidity in the structure of an institution's assets varies greatly with its particular circumstances.

Moreover, a given need for liquidity can be met in many different ways, for example by the regular flow of repayments from loans and investments which are not themselves marketable. Thus, if most loans are short-term, even if not callable, the institution can count on a more substantial cash flow from repayments than if the bulk of its funds is tied up in long-term loans and investments. Again, however, much depends on actual practice: loans which are nominally short-term may in practice remain on the books for long periods and provide less liquidity than long-term commitments on which there is a regular and dependable flow of repayments. Moreover, short-term investments which lack marketability are in fact less liquid than longer-term securities for which a continuing and reliable market exists.[22] Because so many different factors must be taken into account, it is as difficult to prescribe how much of an institution's funds should be invested in specific liquid assets such as callable loans and marketable short-term securities as it is to prescribe common capital ratios. Indeed, circumstances change over time with the development of markets: if secondary markets grow up in assets such as municipal securities and mortgages, or if new discounting facilities are introduced, the effective liquidity of whole classes of assets improves and there is less need to hold other marketable assets.

Taking account of all these considerations, and of the fact that liquid assets which must be held are not in fact a source of usable liquidity, we do not believe that statutory liquidity ratios should be imposed for purposes of public protection by the banking legislation.[23] The public interest will be adequately safeguarded if the authorities keep themselves informed of the circumstances of each institution and have the power to intervene if a particular institution is extending its asset position dangerously or not making adequate provision to meet maturing liabilities. In order to protect the institutions against unnecessary use of this power, any regulations laid down should be subject to appeal to the Treasury Board or some other appropriate body.

We would expect the institutions concerned to support wise supervision in a matter which bears so directly on their own best interests. Indeed, they might well co-operate with the Inspector General of Banks in working out appropriate guide-lines: some institutions have already taken such steps privately within their own associations. We find it difficult to offer any specific advice as to these guidelines or as to the classes of assets which would be included. However, the chartered banks have operated soundly with between 20% and 25% of their assets invested in cash, day and call loans and short-dated federal government obligations. These assets are held against liabilities which are virtually all chequable, a fact which suggests that somewhat similar ratios would be appropriate against demand and chequable liabilities—with somewhat higher ratios being held against current accounts and perhaps somewhat lower ones applying to liabilities redeemable at short notice.

[22] The holders may of course consider such readily marketable long-term assets as less liquid if their price has fallen and sale would involve capital losses: the same is indeed true of marketable short-term investments.

[23] The question of giving the central bank the power to impose or alter liquidity requirements for reasons of monetary policy is discussed in Chapter 22.

The experience of institutions dealing more in genuine term deposits suggests that liquidity ratios against such liabilities might vary from as little as 10% to 20%, depending on the various factors affecting their liability and asset structure mentioned earlier. Nevertheless, the supervisory authorities and institutions are in a better position than we to work out appropriate and more precise guide-lines.

CONCLUSION

We have now completed our recommendations for amendments to the Bank Act and the related Small Loans Act. In recommending a broadening of the former's coverage to include all institutions undertaking a banking function and in proposing an increase in the powers of the Inspector General to ensure that sound practices are followed, we have been guided by the desire to establish a more flexible and equitable framework within which the main purpose of the Act—ensuring the continued soundness of the Canadian banking system—can be carried forward along proven paths and adapted to changing conditions. Our recommendation that minimum cash reserve ratios be imposed on all banking institutions, that they vary with the nature of liabilities and that they be held at the Bank of Canada should also serve to encourage sound practices and promote equity among institutions. Moreover, it will foster more contacts and consultation between the authorities and the institutions concerned—on both financial developments and policy matters—as well as adding somewhat to the predictability of institutional response to monetary measures.

As with the recommendations on the broader investment spirit and provisions of the Act set out in Chapter 18, this regulatory framework has been designed to encourage the financial system to be adaptable and creative within a competitive and non-discriminatory environment in which there will be fewer arbitrary legislative distinctions and prohibitions than are now to be found. In some cases we have suggested putting on a statutory basis effective controls which already exist, while in others our proposals are designed to fill gaps or loopholes in the regulatory framework or to make provision for future developments.

We have also tried to reconcile a broad and equitable national approach with a pattern which allows for the decentralized operation of the financial system, which encourages smaller institutions, and which enables co-operative movements like the credit unions and caisses populaires to be regulated only through their central institutions. The provisions which we have suggested may need to be altered with experience, but we would hope that any modifications would, like the proposals we have just put forward, be viewed in the perspective of the whole financial system. In the ordinary course of events the usual parliamentary review at ten year intervals would probably be often enough to keep the regulatory framework attuned to the needs of the country.

CHAPTER 20

THE OBJECTIVES OF POLICY

We have thus far been primarily concerned with the financial system's role in channelling funds from lenders to borrowers. Yet the freest and most highly competitive of financial markets and the soundest of regulatory frameworks are not enough to guarantee attainment of broader economic objectives such as full employment and price stability. Measurable success in reaching these goals depends upon governments making carefully and consistently co-ordinated efforts to achieve them. We therefore turn to examine the working and effectiveness of various financial policies—with particular stress on measures designed to influence credit conditions. But monetary and debt policies—which are dealt with in Chapters 21 and 22—are only part of a wider policy structure, each component of which has important effects on the others. We have thus found it necessary to examine international financial policy and fiscal policy before we draw together our conclusions as to the factors governing the choice and combination of policies in Chapter 25. It is in this wider context that we deal with the status and organization of the Bank of Canada in Chapter 26.

THE CHARACTERISTICS OF ECONOMIC OBJECTIVES

Any analysis of broad economic objectives and financial policy quickly leads to a fundamental dilemma: society's major goals do not lend themselves to sharp definition, yet policy is likely to be blurred and aimless if it is not sighted on a clear target. Any extended discussion of economic objectives must therefore avoid the danger of becoming either a carefully contrived model of arithmetic unreality or an eloquent exercise in generalized vagueness. Each segment of the community has its own special interests and sense of what is important and finds it difficult to agree with others on any precise policy goals for society as a whole. The list of economic objectives which emerged from our extensive exploration of the subject with domestic and foreign witnesses was consequently a long one and while there was general agreement that rising efficiency, high and stable levels of employment, price stability and a sound external position could be classed as pre-eminent objectives, there was much less agreement on their specific content or, in some cases, on their priority. Moreover, even such broad economic goals as these do not always receive continuous public support and are subservient to the constantly shifting political philosophy of society. The community may readily enough agree that all Canadians should enjoy the maximum freedom consistent with reasonable equality of opportunity and a fair sharing of national burdens and benefits, but there is no formula for translating such imprecise views into a set of workable economic objectives.

All policy must therefore be an exercise in choice, but the choices are never absolute and the circumstances in which they must be made are continually changing. Goals which may be

easily attained when the world economic environment is buoyant may be impossible to reach when the international climate is less favourable. Similarly, if the country has just gone through a prolonged period of high investment and is suffering from excess capacity, or if attitudes towards work and enterprise have become unfavourable, our economic objectives may become at least temporarily very difficult to achieve. Many factors which influence our economic performance are outside the reach of the policy-makers, particularly those responsible for financial policy—clearly, no amount of monetary ease will cure unemployment owing to a crop failure or to the existence of uncompetitive industries. One would like to have economic objectives precisely stated in order to have a yardstick against which to measure the performance of financial policy. Yet we are convinced that an attempt to establish the appropriate balance of objectives by an unchanging set of rules would lead to unreality and error, particularly in an open and constantly changing society with its many conflicting aspirations.

Having said this, we still believe it vital that the public and the authorities have their objectives clearly in mind and agreed at any point in time. These objectives may not be exactly the same from one period to another, but a consistent policy program cannot be worked out to deal with a particular situation unless it aims at some specific target and its costs and benefits are as carefully calculated as circumstance will allow. If society cannot agree to support a common objective, even temporarily, or if the policies of the authorities are inconsistent and taken with only the vaguest regard to the consequences, the results are bound to be unsatisfactory. The number of people without jobs and looking for work will obviously be higher than it otherwise might have been if the community cannot agree either on the need to combat unemployment or on well-defined measures to remedy it. Our economic performance thus depends on the public giving informed and enlightened support to the objectives of the time, on the political authorities exercising leadership to bring about agreement on major economic goals, and on the policy-makers having a consistent and carefully-calculated program to achieve these aims.

A REVIEW OF OBJECTIVES

We believe that Canadians would now agree that the following four very broad economic objectives should be pursued by the authorities and the nation generally:

(*a*) Rising productivity;

(*b*) A high and stable level of employment;

(*c*) Stable prices;

(*d*) A sound external financial position.

Rising productivity is not, of course, an end in itself but a means of improving the economic welfare of the nation. If it is coupled with high employment, national output will grow, and the country may devote this gain in well-being to a higher standard of consumption, to increased leisure, or to expanded investment at home and more assistance to the undeveloped nations. Whether consumed or invested, enjoyed at home or given away, the rising incomes of a nation becoming steadily richer mean that its citizens have more choices open to them than one which is poor, stagnant, or declining. How wisely the fruits of this progress will be used is another question. We were urged by different witnesses to stress that increases in particular kinds of expenditures should be regarded as prime objectives of policy: some urged that more resources be devoted to schools, roads, or housing; others emphasized consumption or welfare payments; and still others private investment or the development of export and import-competing industries. Society will wish to resolve these many conflicting claims to scarce resources—for social capital, private investment, or consumption—in different ways at different times, and this will lead to policies designed to stimulate one kind of output rather than another. However, too much interference with the normal incentives which cause free markets to change their output in response to changing tastes and technology, or too much attention to highly specific subsidiary goals, is

likely to impede growth. In general, the more successful we are in achieving our broad objectives for the economy as a whole, the greater will be the opportunity to meet the special needs of individual segments of it. In particular, a satisfactory rate of overall growth stemming from rising productivity and high employment will make it easier for industries which are declining relatively or absolutely to adjust their positions, for labour and capital to find new and profitable employment, and for the nation to extend any desired support to those left behind by the forces of progress.

Growth stemming from rising efficiency must be distinguished from the once-for-all gains that can occur from drawing more people into the labour force, from reducing unemployment, or from lengthening working times. Some would add that it is a national objective to encourage national expansion through immigration, but however measured, growth, if it is to be strong and sustainable and not liable to come to an early end, cannot be based on wasteful expenditures. Rather, it must be primarily dependent on continuing adequate levels of investment—in human and social capital as well as in business and consumer assets —on advances in productive techniques which combine labour, management and capital more effectively, and on improving the quality and enterprise of the working population generally. Such increased productivity and competitiveness enable an increased output of goods and services to be realized from each unit of input.[1] If productivity is rising rapidly and if the level of employment is kept high and stable, total national output will show satisfactory gains. Since 1957, both productivity increases and the level of employment have been unsatisfactory.

Unemployment is universally recognized as an economic problem. Success in meeting the objective of promoting desirable levels of employment can therefore best be measured not by total employment (which may vary with immigration, population trends, and the number of people wanting to work) but by the proportion of the labour force which is unemployed and genuinely seeking work.[2] As with the productivity objective, high and steady levels of employment are not ends in themselves but means of enhancing economic, social, and individual well-being and of offering reasonable opportunities to all who wish to take advantage of them. There is no intrinsic merit in drudgery and even less in employing half the population to dig holes and the other half to fill them in. What we seek in espousing the objective of high employment is, of course, the removal of the material and psychological distress of the unemployed and avoidance of the loss of production which unemployment involves. If sufficient productive employment opportunities are available, the country as a whole will enjoy higher real incomes per person, a larger national output and a climate more favourable to efficiency and growth.

The objective of stable prices too, while desirable for its own sake, is also important as a means to a wider end. A cumulative and pronounced rising or falling trend in the *general* level of prices can be socially and economically disrupting, although prices of individual goods and services, and financial assets should move freely because it is through such *relative* price movements that most of our resources and expenditures are allocated. While studies carried out for us confirm that the hardship wrought by inflation falls mainly on older people, those living on fixed incomes and some categories of lower income wage earners, it is clearly an important objective of policy to protect these groups against a discriminatory erosion of their living standards from which they have no adequate means of protecting themselves. Unemployment and infla-

[1] Perhaps the best indicator of the real output of the economy (the value of production corrected for price changes) is the series "gross domestic product at factor cost", while the most suitable measure of input appears to be manhours of labour, although statistics on hours worked outside the manufacturing sector are not yet adequate.

[2] The D.B.S. series "unemployment as a per cent of the labour force" appears to be a broadly accurate gauge of the unemployed, despite the fact that it may include a few people who have no intention of looking for jobs. Nor is there any reason to suspect that it distorts the trend of unemployment. This is especially true if the index is corrected for seasonal variations.

tion may each affect only a small part of our society—but both can destroy savings and morale in ways which the country as a whole cannot ignore. Moreover, rising prices can weaken real economic growth by undermining the system of fixed value contracts on which efficient business is founded, by generating a fear of long-term saving and lending commitments, and by diverting real resources into unproductive and inefficient channels as individuals and businesses seek to escape inflation's harmful effects. Inflation may also proceed more rapidly at home than abroad, thus discouraging both Canadians and foreigners from buying our output and frustrating efforts to maintain desirable levels of productive employment. A climate of continuous deflation is even more unlikely to lead to the realization of the goals of employment, efficiency, and a sound international economic environment.

We received a suggestion that the best measure for judging the stability of prices is the wholesale price index of commodities. Yet if prices of the goods-producing industries never fall because productivity gains are fully absorbed by increased wages and profits, the resulting pressure on wages in the service industries where productivity gains are smaller would be almost certain to lead to higher prices in this sector. The result would be a steadily rising consumer price index. Moreover, our international competitive position would be undermined if other countries kept final prices stable and allowed productivity gains to be shared between labour, management, and the community generally. Nor is the wholesale price index a particularly accurate measure of price trends in the economy as a whole. We believe that the consumer price index is a reasonably reliable indicator of final prices, although a study carried out for us showed that it had a slight tendency to overstate price increases because of the difficulties of measuring quality changes, improvements in services, and related matters. These biases are not thought to be significant for the index as a whole, but we believe D.B.S. should continue to devote more resources to improving the accuracy of this index. Although it does not measure changes in living costs which stem from changes in tastes and patterns of consumption, the consumer price index appears to be more reliable than the price deflator for total national output which, despite improvements, still has serious upward biases, particularly in the area of investment and service prices.[3]

The goals of stable prices, efficiency and full employment are purely internal although their achievement can also make a worthwhile contribution to a better world economic climate. Yet we are unlikely to reach these objectives if our external financial position is unsound and our relationship with the outside world unhealthy. Canada has always been an open economy and our progress and prosperity are still inseparably linked to international economic developments, particularly those in the United States. Our extensive financial, trading, and other ties abroad, the world's increasing interdependence, and closer economic co-operation between nations all make it virtually impossible for us to insulate ourselves from events elsewhere. Indeed, it would be disastrous even to attempt to do so. Paradoxical as it may seem, the more successful we are in achieving strong and balanced external finances, the more independence we have to pursue domestic goals: full employment gets no priority in an exchange crisis, and prices cannot remain stable if the foreign exchange value of the Canadian dollar undergoes continuous deterioration.

Just as there are those who favour a particular composition of domestic output, so there are people who believe the nation's international objectives should be defined in highly specific terms. There is a view, for example that Canadian external economic policy can best serve our long-run interests by increasing foreign aid and bringing about a stronger world monetary, trade and economic system. Another strand of thought puts emphasis on replacing the current account deficit in our balance of payments by a surplus, partly to make us a net contributor to—rather than user of—the world's scarce supplies

[3] See *The Reliability of Selected Price Indexes as Measures of Price Trends,* prepared for us by A. Asimakopulos.

of physical capital and other resources, and partly because it is felt that our economic independence would be enhanced. A related view is that imports of equity capital should be discouraged and that increased domestic ownership would give us more control of our economic and political destinies. Most of the witnesses before us favoured a fixed exchange rate or a relatively stable rate, but others put forward the extreme view that no concern at all should be expressed about the exchange rate and that it should be left to find any level consistent with the achievement of domestic objectives. However, these differing and sometimes conflicting viewpoints seem to us to be dealing with essentially intermediate goals. The wider objective must be an external financial position which enables us to pursue national goals —including the broad political aim of promoting a stronger world economy—with as much independence as our obligations to an interdependent world will allow.

Because it is in fact a complex of goals, there is no single measure which summarizes this objective. Stability of the spot or forward foreign exchange value of the Canadian dollar is not by itself an adequate measure of performance, particularly if it is achieved by sacrificing domestic price stability and employment or by imposing trade and exchange barriers. Wide swings in the external value of the currency are disruptive at home and abroad under any system of rates, but past experience suggests that there may be times when changes will be necessary. Nor can the only guide be the size of the nation's reserves of acceptable means of international settlement in the form of gold, U.S. dollars and other convertible currencies. Continuous and pronounced changes in the reserves (excluding borrowed reserves) may indicate unsound developments, but difficulties are not always immediately reflected in this way nor are all reserve changes necessarily symptomatic of basic problems.

The current account balance with other countries can also be a useful indicator of the external position. Yet deficits in our international accounts may reflect nothing more than vigorous growth and full utilization of domestic resources accompanied by profitable opportunities to employ foreign funds. At other times, such deficits may indeed be an indication of fundamental competitive weakness, of unjustified foreign borrowing or of increasing vulnerability to external events.[4] Nor do current account surpluses necessarily reflect a healthy economy, especially if they result from trade restrictions, inflation abroad, or unemployment and stagnation at home.

Yet another indicator of the soundness of Canada's external position is the composition and size of capital flows. Like those of an individual enterprise, however, a nation's outside borrowings should be viewed not in absolute terms but in relation to its income, capital program and the returns on investment. For example, inflows of a fixed-interest nature are only a potential source of trouble if repayment commitments are large in relation to domestic incomes or exports while equity flows can be considered undesirable in non-economic terms only when they represent a sizable proportion of such financing in Canada.[5] On economic grounds, the value of direct investment must be judged by the contribution it makes to economic growth through providing Canada with real resources, extra incomes and new markets, skills and industrial techniques.

Perhaps enough has been said to indicate the complex and elusive nature of the nation's external economic objective. Like a business or individual, an economy cannot long mismanage its affairs without incurring external difficulties. If the country tries to do more than available real resources—domestic and foreign—will allow, serious consequences are bound to follow. Similarly, if inappropriately restrictive policies are pursued when there are unemployed resources in Canada, excessive inflows of capital may be attracted. Nor would the world economy benefit from such an enforced reduction in Canadian incomes and employment. Just as individual units within Canada must be vitally concerned with

[4] Much depends on whether such deficits are the result of temporary or more permanent forces affecting the costs and markets of our export or import-competing industries.

[5] Such equity inflows can occur even with a current account surplus if there are offsetting capital items or reserve changes.

the health of the economy as a whole, so must Canada be concerned with the well-being of the world economy and base its policies accordingly. Short-sighted steps which yield near-term gains at the expense of weakening international trade and financial arrangements are no way to achieve continuing domestic prosperity or a sound international environment. Essentially then, the external goal must be to manage Canada's international dealings with enough foresight to promote rather than sacrifice her broad, domestic political and economic aims in the long run.

The more numerous and specific these goals of the Canadian people become, the more complex becomes the task of obtaining general support for them and the greater is the possibility that they will conflict with each other. We have tried to focus attention on the major goals which we believe command the broad backing of the community, but even these few objectives are not easy to attain and have on occasion proved impossible to reconcile. Before turning to look briefly at the post-war record and the question of conflicts among objectives, however, it should be stressed again that all failures or successes are not to be laid at the door of the policy-makers, especially the monetary managers. Much depends on the world environment and other fundamental factors affecting the behaviour of the Canadian economy.

THE POST-WAR RECORD

Although short-run economic developments in Canada have to some extent a life of their own, the economy's performance can only be fully understood when viewed against the longer-term trends which influence its underlying tone and atmosphere. Some economists have disputed the existence of well-defined "long cycles" having a common cause, but whatever the merits of their case there clearly seem to be periods when a conjuncture of domestic and world events like population growth, innovations and technological progress, and the "bunching" of consumer and investment spending combine to create long waves of vigorous growth. Conversely, there appear to be extended periods when for one reason or another resources are relatively abundant and the economy lacks the driving forces of demand which alone can spur it to top performance.[6] Thus, although the short-run business cycle remains in many ways the most convenient method of chronicling economic events, its course must be related to the longer-run climate. These short cycles normally consist of expansions in a number of activities at about the same time, followed by comparable generalized contractions which in turn give way to the expansionary phase of the next cycle. While cycles in other countries have been as long as twelve years, the following table shows that Canadian cycles have typically averaged closer to four years in the post-war period.

TABLE 20–1

BUSINESS CYCLE REFERENCE DATES—
CANADA, POST-WAR PERIOD

Year	Quarter	Month	Turning Point	Type and Number of Phase Begun
1946	I	February	Trough	Expansion 1
1948	IV	October	Peak	Contraction 1
1949	III	September	Trough	Expansion 2
1953	II	May	Peak	Contraction 2
1954	II	June	Trough	Expansion 3
1957	II	April	Peak	Contraction 3
1958	II	April	Trough	Expansion 4
1960	I	January	Peak	Contraction 4
1961	I	March	Trough	Expansion 5

NOTE: Periods of contraction are indicated by shading in all charts in this chapter.

Canadian experience since 1946 can conveniently be divided into four periods. The first, from the completion of post-war reconversion and demobilization until 1949, was a time of strong demand resulting from the aftermath of war. The second, which lasted until 1953, was also one of strong demand, but was based on peacetime expansion and development as well as the special stimulus from the Korean War which broke out

[6] See the appendix volume for a further discussion of long cycles and their history.

in June 1950. The third, which followed an inventory adjustment and curtailment of U.S. defence expenditures in late 1953 and early 1954 —paralleled by a recession in Canada—was marked by a vigorous investment boom triggered in part by world-wide fears of raw material shortages. Following 1957, however, the whole climate facing Canada changed. During this fourth period, domestic spending became less vigorous as accumulated consumer demands were satisfied and spare capacity emerged in many industries, particularly in basic raw mtaerials. This was the result both of earlier heavy investment programs and the weakened competitive position of North American producers. Reflecting the need for fundamental adjustments to these deep-seated changes in demand, the recovery phases of the business cycle tended to become shorter and less complete, although contractions did not become longer or more severe.

Chart 20-1, which shows the trends in real gross national expenditure[7] and its year-to-year changes, illustrates the vigour with which Canadian output was growing before 1957 and the flattening out in subsequent years. Immediately after the war, the backlog of domestic demand for consumer and investment goods supported by heavy war-time accumulation of liquid assets, the need to provide assistance to the war-torn European nations and the absence of international competition combined to put heavy demands on our resources. Indeed, the expansion of Canadian output barely slackened during the mild American recession of 1949 and the demands of recovery and of the Korean War again taxed our capacity fully in the years which followed. Small absolute declines occurred in 1951 and in the 1953-54 recession, but there was vigorous expansion in the ensuing investment boom until the sharp drop in the growth rate two years later. As can also be seen from the chart, these developments closely paralleled those in the United States, although Canadian recessions were milder and expansions more pronounced—except for the 1958-60 recovery. These developments in our growth rate are brought out even more sharply by Chart 20-2 which shows real gross national expenditure per person and year-to-year changes in this figure. If G.N.E. in constant dollars per person employed were used as an approximate measure of productivity, it would show that output per employee in all sectors (including agriculture) rose by approximately 2.7% annually from 1946 to 1956, compared to just over 1% from 1956 to 1962.

Unemployment rates reflected these developments, being very low in the early post-war period when resources were under strain, but moving up quite sharply even in the mildest recessions. However, apart from one quarter in 1950, deseasonalized unemployment did not exceed 4% of the labour force until the 1954 recession and even then did not remain long at the higher level. As chart 20-3 shows, however, the unemployment figure has not been under 5% since 1957 in either Canada or the United States. Moreover, our unemployment rates were above American rates from 1958 to 1962, partly because our higher rate of increase in the labour force had not been matched by a correspondingly higher rate of economic growth. While some of this unemployment is structural in the sense that there are job openings for which the available unemployed lack skills or training, it is worth noting that by far the largest part of the jobless total stems from generalized weakness of demand. Thus we find that all areas of the country and virtually every occupational group experienced higher unemployment rates after 1957 than they did before, although the burden continues to be heavier in some regions, occupations, and age groups than in others.[8]

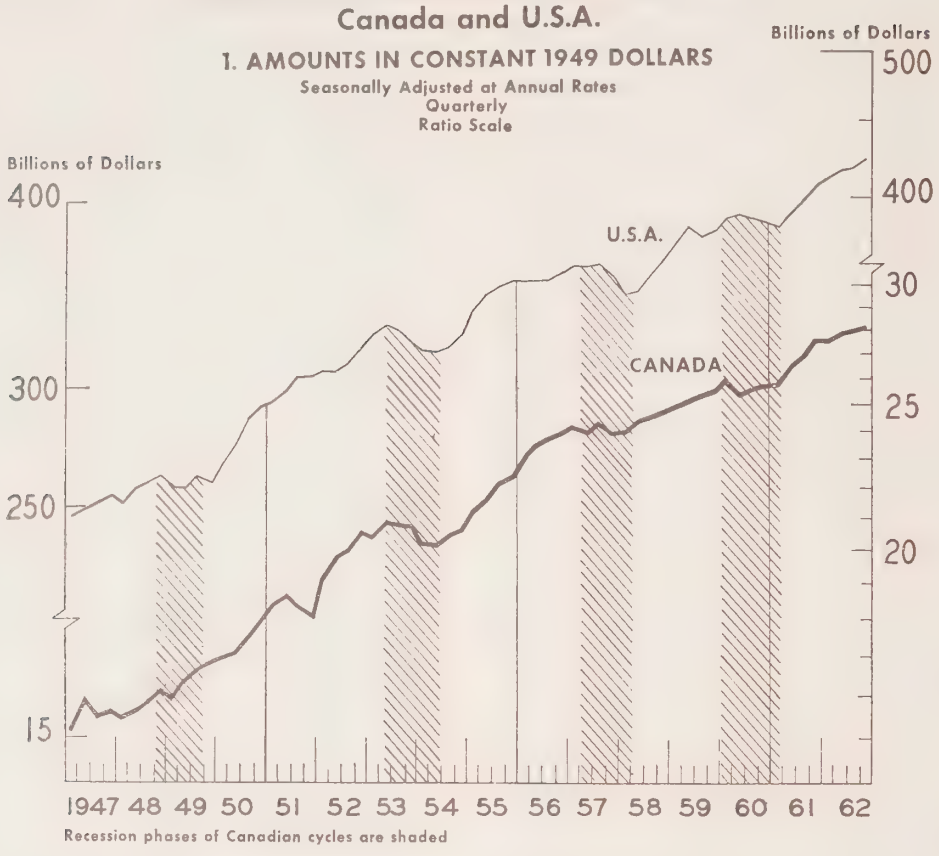
While it has only been in recent years that we have failed to achieve our productivity and em-

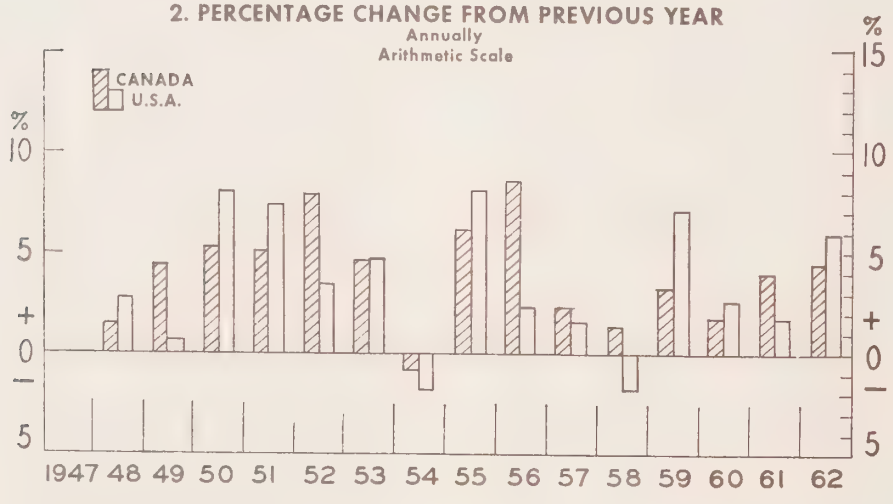
[7] Gross domestic product at factor cost would be a preferable measure, but for the sake of making comparisons with the United States it is not used here.

[8] See *Report of the Special Committee of the Senate on Manpower and Employment*, Queen's Printer, 1961, which gives the detailed structure of Canadian unemployment and which brings out the heavier concentration of unemployment among men, the younger worker, the unskilled, etc.

Chart 20-1

REAL GROSS NATIONAL EXPENDITURE*
Canada and U.S.A.



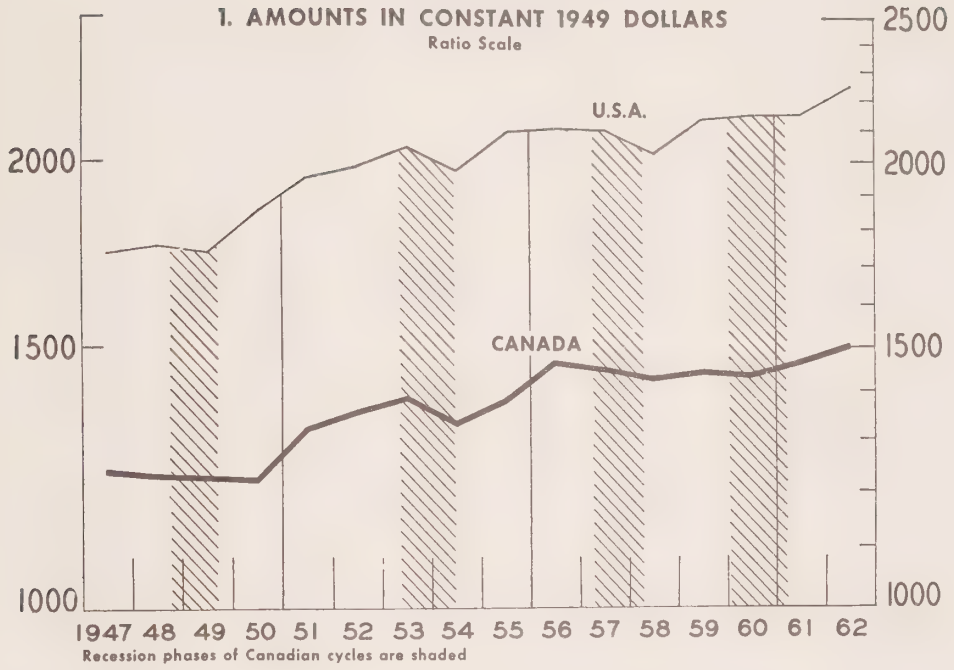


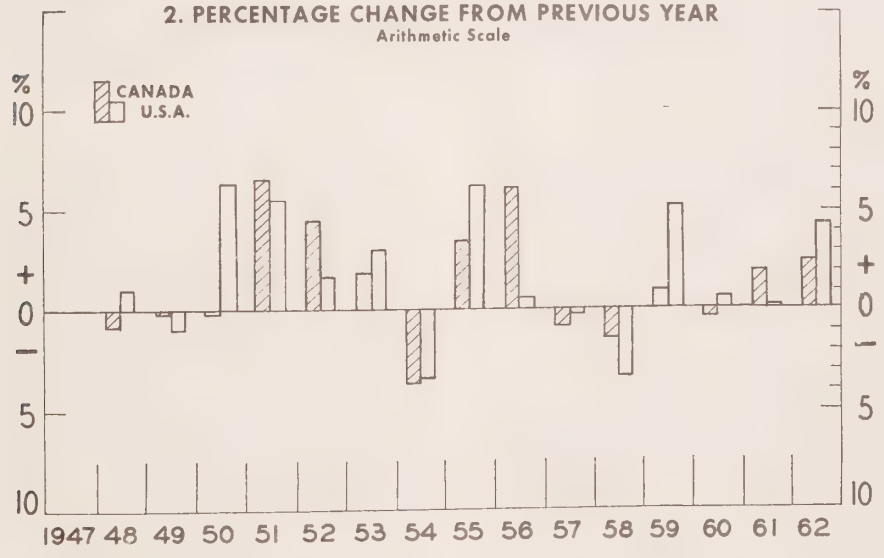
*Excludes change in farm inventories

Chart 20-2

REAL GROSS NATIONAL EXPENDITURE* PER PERSON Canada and U.S.A.

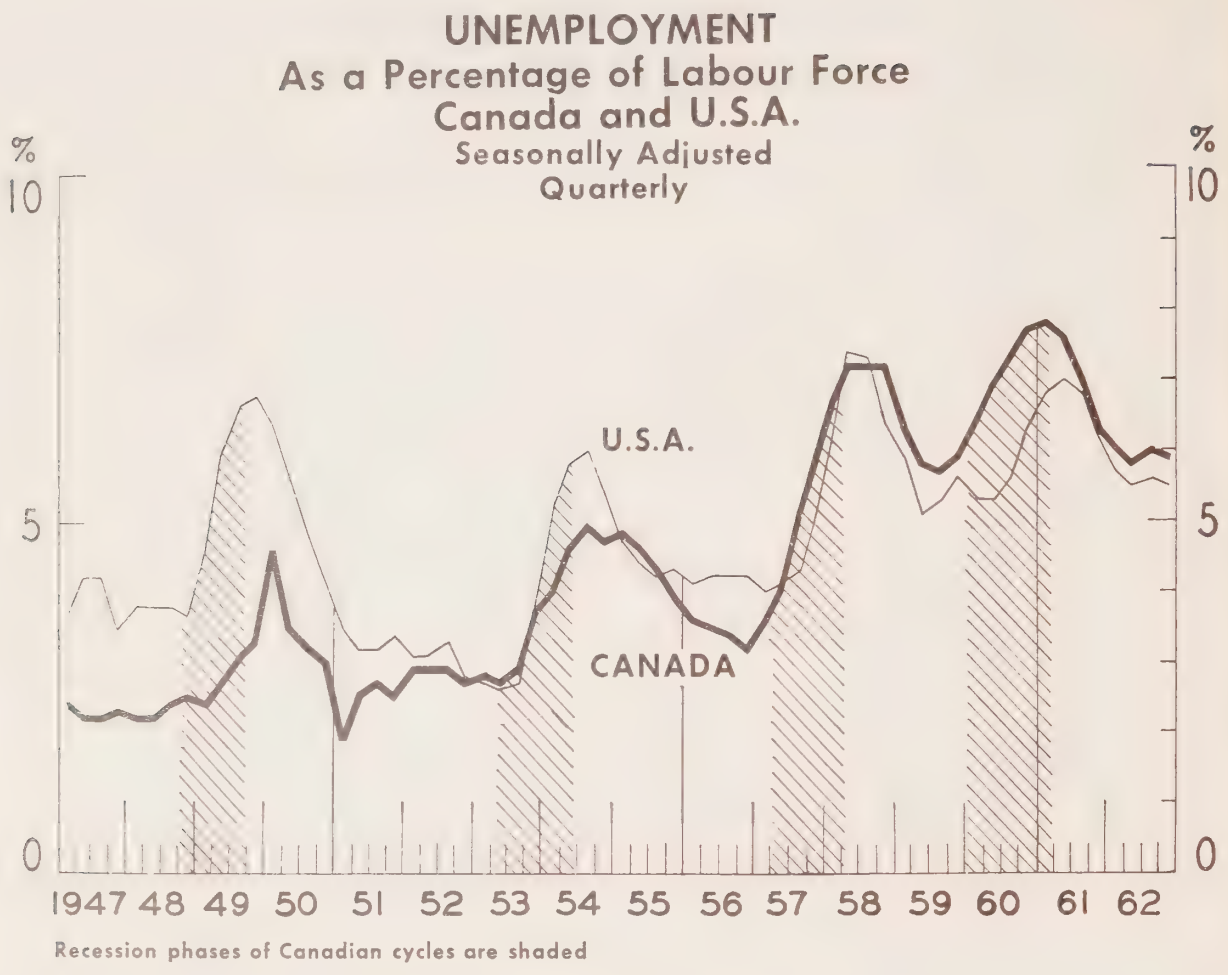
Annually





*Excludes change in farm inventories

Chart 20-3



ployment objectives, the most pronounced shortfall from the target of stable prices occurred in the early post-war years. Strong demand—made effective by large public holdings of money and government bonds accumulated during the war—and wide-spread shortages led to the sharp inflation of prices shown in Chart 20-4. As can be seen from the shaded bars at the bottom of the chart, such increases reached a peak annual rate of almost 15% in 1947 By late 1948, however, these forces had spent themselves and prices became virtually stable until the Korean War triggered off world-wide fears of inflation and strong demand for goods of all kinds which led to another sharp upsurge in prices in late 1950 and 1951. From that time until early 1956, prices were once again relatively stable because of falling agricultural prices, large productivity increases, and more competitive conditions generally. However, the pressure of the investment boom on labour rates and other costs then began to make itself felt and consumer prices rose at over 2% a year, continuing to do so even after the peak in economic activity had passed. Since 1959, however, price changes have been smaller, with increases, particularly in basic commodities, being less than normal for expansions. These trends have broadly paralleled those in the United States, providing yet

Chart 20-4

CONSUMER PRICE INDEX
Canada and U.S.A.

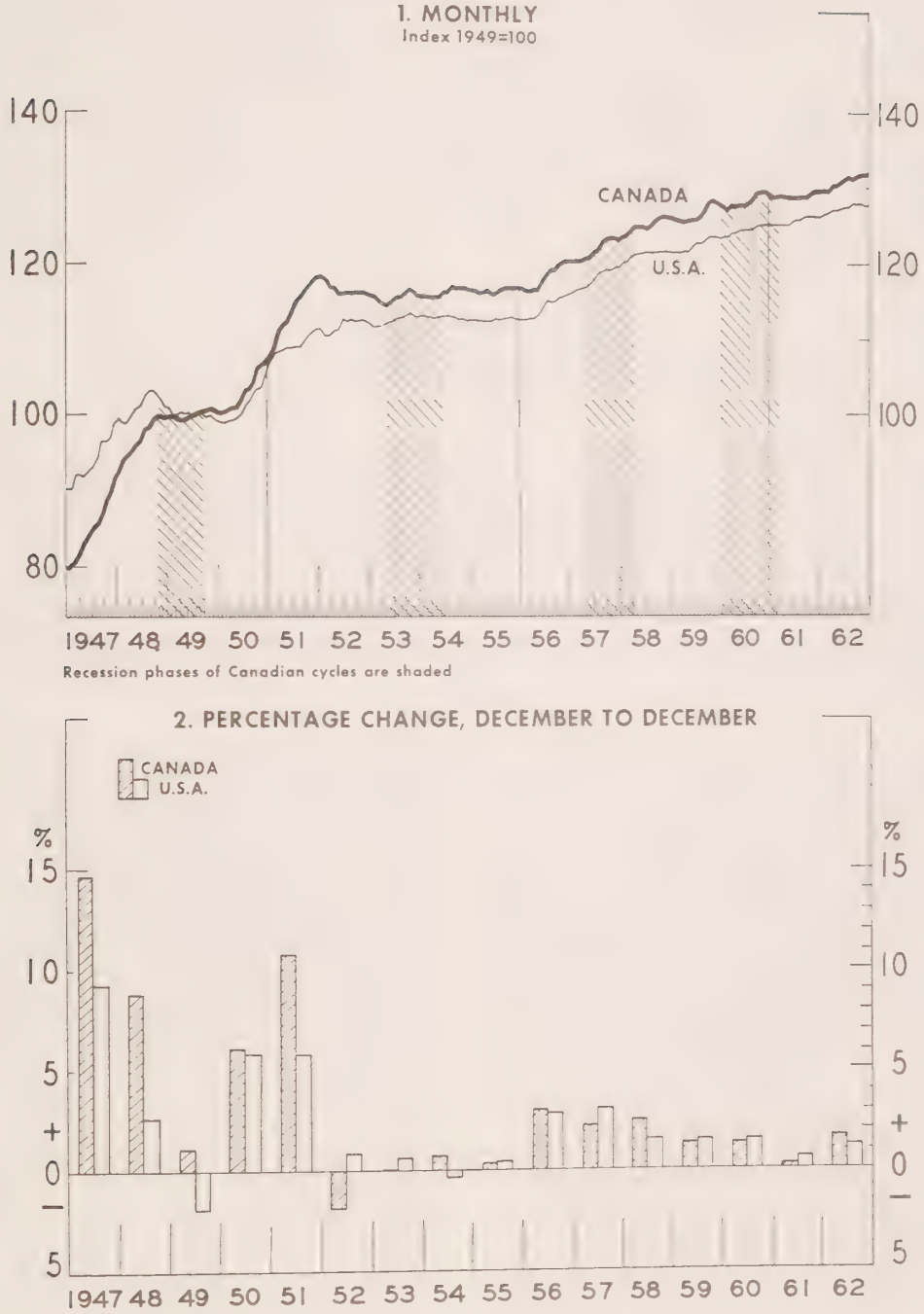
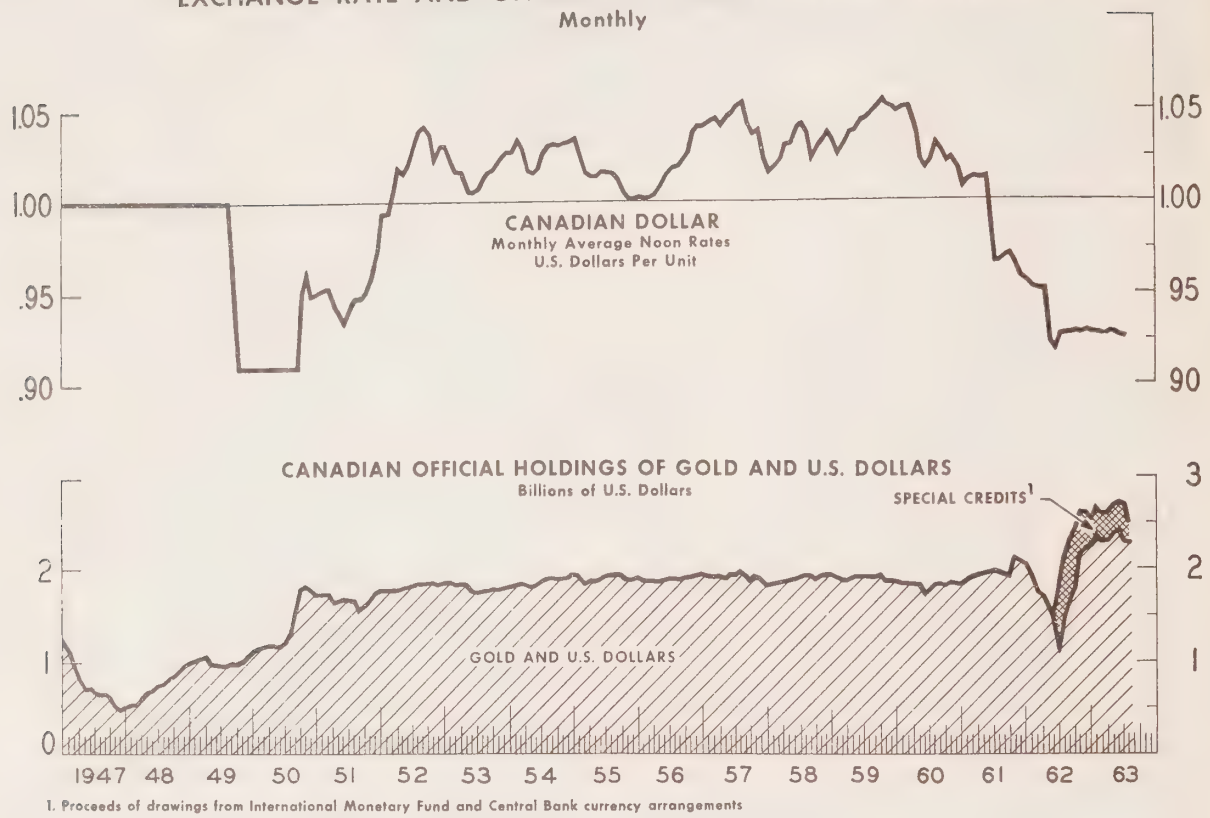


Chart 20-5

EXCHANGE RATE AND OFFICIAL FOREIGN EXCHANGE RESERVES

Monthly

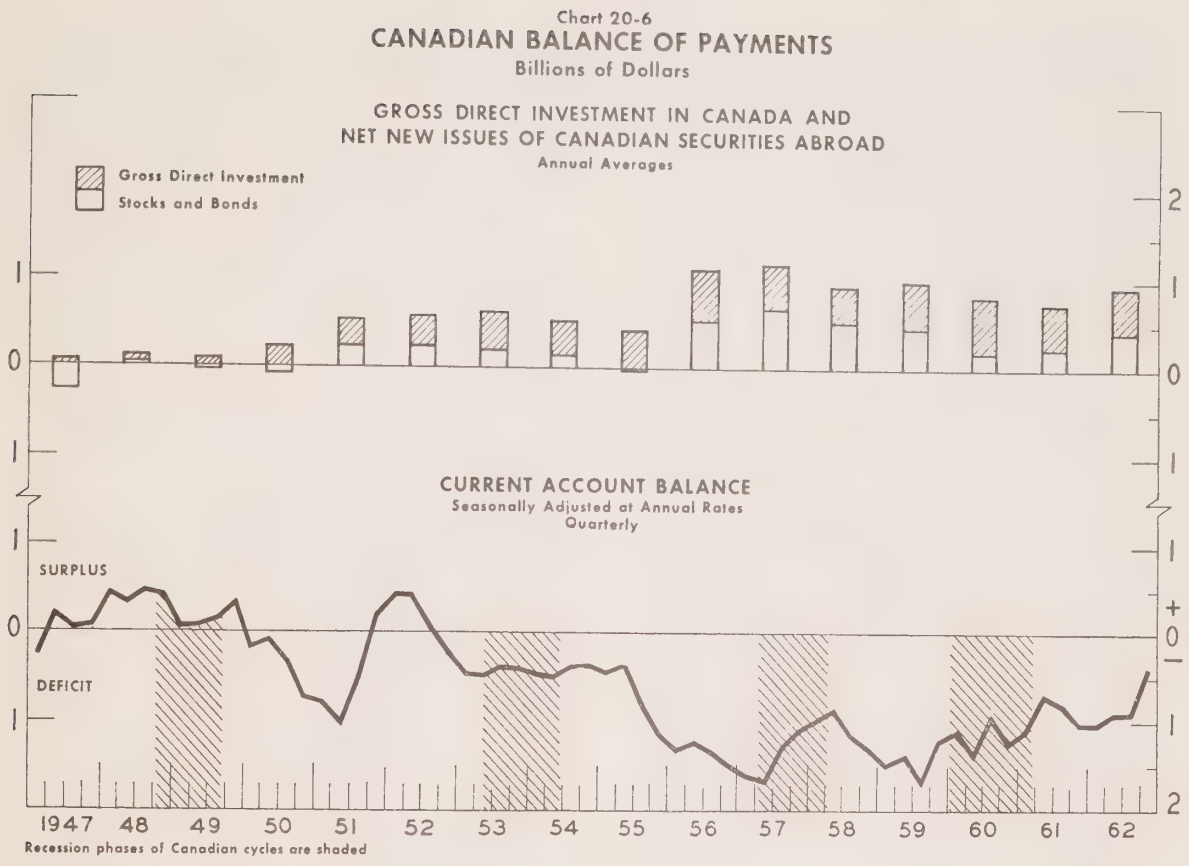


1. Proceeds of drawings from International Monetary Fund and Central Bank currency arrangements

another illustration of our close economic links with that country.

Turning now to the international objective, Chart 20-5 shows the foreign exchange value of the Canadian dollar and the size of official reserves and Chart 20-6 shows the current account balance and the gross amounts of direct investment by non residents and net new securities issues abroad. The Canadian dollar was revalued from a 10% discount to parity with the American dollar in 1946, partly in the belief that our competitive position had strengthened and partly to soften inflationary pressures originating abroad. However, from mid-1946 our exchange reserves declined drastically to under $500 million by November 1947, largely because the continuing, but reduced, surplus on current account was more than offset by the large reconstruction loans being extended to the United Kingdom and European countries. Import controls, special excise taxes and restrictions on consumer credit were then imposed by the government; together with the proceeds of government borrowing abroad and continued heavy inflation in other countries, these measures brought about a significant improvement in our current account and reserve position. When in 1949 the overseas countries underwent major devaluations to reflect the fundamental changes that had taken place in their competitive position, our dollar was devalued by 10%.

By late 1950 this rate proved untenable, despite the emergence of a current account deficit stemming from the improved position of the European economies and the strain on our domestic resources. Foreign direct investment in Canadian enterprises more than doubled as the United States



became concerned about shortages of strategic materials. Growing conviction that our exchange rate could not be held led also to massive speculative inflows which—despite the attempts of the monetary authorities—could not be handled without a dangerous expansion of the money supply. Accordingly, in late 1950 the Canadian dollar was set free to find its own level and worked its way to a premium in 1952. From then until 1960, the authorities restricted their interventions to evening out erratic short-term fluctuations in the exchange rate, and official reserves remained broadly unchanged. The dollar remained at a premium throughout this whole period, despite the emergence of very large current account deficits in every year but 1952, when agricultural exports were unusually strong. In all these years direct investment remained high, with the result that even a policy of very active monetary ease in the recession of 1954 did not bring about any absolute decline in the dollar's value. In 1955, however, the persistence of monetary ease in Canada brought about a narrower interest differential with the United States and the rate declined by about 3% in that year. As the investment boom gathered force and monetary policy shifted to restraint, the dollar strengthened sharply, partly because of heavy Canadian security issues in the New York market. Since Canadian interest rates were maintained at relatively high levels after 1957 despite the emerging weaknesses in demand, such security issues remained large and reinforced the support our dollar was receiving from direct investment inflows.

In December 1960, the government announced it believed the premium rate inappropri-

ate to the slacker conditions which had by then prevailed for some time and imposed higher withholding taxes on interest and dividends going abroad in an attempt to force the rate to a "significant discount". Also, for the first time in almost a decade the authorities began to intervene directly in the exchange market to bring down the rate; a discount of over 4% was actually reached by the end of 1961 as a result of this policy, which was announced in the 1961 budget, and of a sharp drop in foreign borrowing by Canadian residents. By early 1962, however, uncertainties over government policy and the outcome of the pending election had started a massive run on the Canadian dollar, and despite the return to a fixed rate at a value equal to 92.5¢ U.S. in May, the reserves had fallen to $1,100 million by June. Special measures were taken to stem the tide, including the imposition of tariff surcharges, sizable borrowings from the International Monetary Fund and others, a curtailment of government expenditures, and sharp increases in interest rates. The reserves responded quickly and by early 1964 all these special measures, with the exception of reduced tourist exemptions, had been removed or relaxed and all temporary foreign borrowing—other than part of the I.M.F. credit—had been repaid.

Despite the strength of the Canadian dollar between 1950 and 1960, the international competitive position of Canadian industry deteriorated. Chart 20-7 shows Canadian labour costs per unit of output compared to those in the United States: these labour costs rise whenever productivity gains fall short of the increase in average hourly earnings. In the years when the demand for Canadian resources exceeded the available supply, this weakening competitive position did not result in serious general problems, but following 1957 it contributed to the difficulties experienced in bringing our current account into a more satisfactory position. These difficulties were made more intense by the active competition from the reconstructed and modernized economies of Europe and Japan whose position underwent dramatic improvements. However, rising inflationary pressures and the recent slowing of the growth rates of those economies have eased this problem somewhat. In addition, Canadian management and labour—long accustomed to passing on higher costs to the consumer—have become more realistic and competitive in their attitudes in recent years, while the recent decline in the value of the Canadian dollar has helped their position further. There has thus been a marked improvement in our current account balance, the deficit of over $1.4 billion in 1957 and 1959 having been reduced in 1963 to approximately $500 million. The improvement in the merchandise account has been even more striking, from a deficit of over $700 million in 1956 to a sizable surplus in 1963.[9]

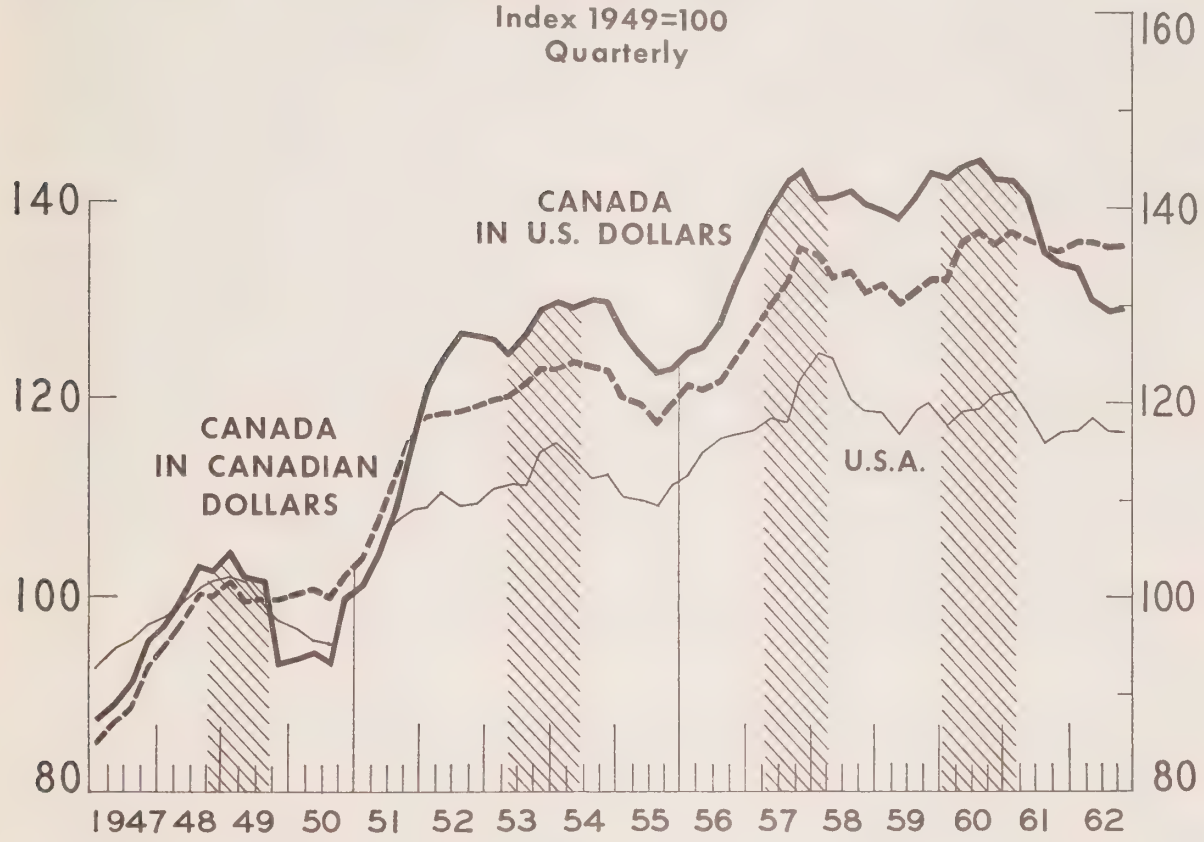
Domestic financial policies in the post-war period have also showed marked changes. In the early years after the war, monetary policy was virtually unused as a restraining influence, bank rate was set at a low level and the rate on long-term government bonds was kept between 2.60% and 3%. This reflected world-wide scepticism about the short-run effectiveness of monetary policy, a belief that a slump was not far away and that easy credit conditions would soon be appropriate in any event, and concern about the problem of managing the huge debt incurred by the government to finance the war. Thus, monetary policy played no part in combatting the post-war inflation or the exchange difficulties in 1947 and, indeed, the policy of supporting government bonds above or close to par meant that the central bank and government accounts were making it particularly easy for the public to cash in its holdings of these instruments to finance its post-war spending spree. The stock of money—already at record levels in relation to G.N.P.—was allowed to expand further from 1946 to 1948 when inflationary pressure was at its height. The resulting extra liquidity could only be worked off through additional price increases, and it was these price increases—illustrated in Chart 20-4—which brought about the decline in the ratio of money supply to G.N.P. shown in Chart 20-8.

With the outbreak of the Korean War and the limits which heavy defence expenditures put on

[9] See also Chart 4 in Chapter 5.

Chart 20-7

LABOUR COST PER UNIT OF OUTPUT IN MANUFACTURING
Canada and U.S.A.
Index 1949=100
Quarterly

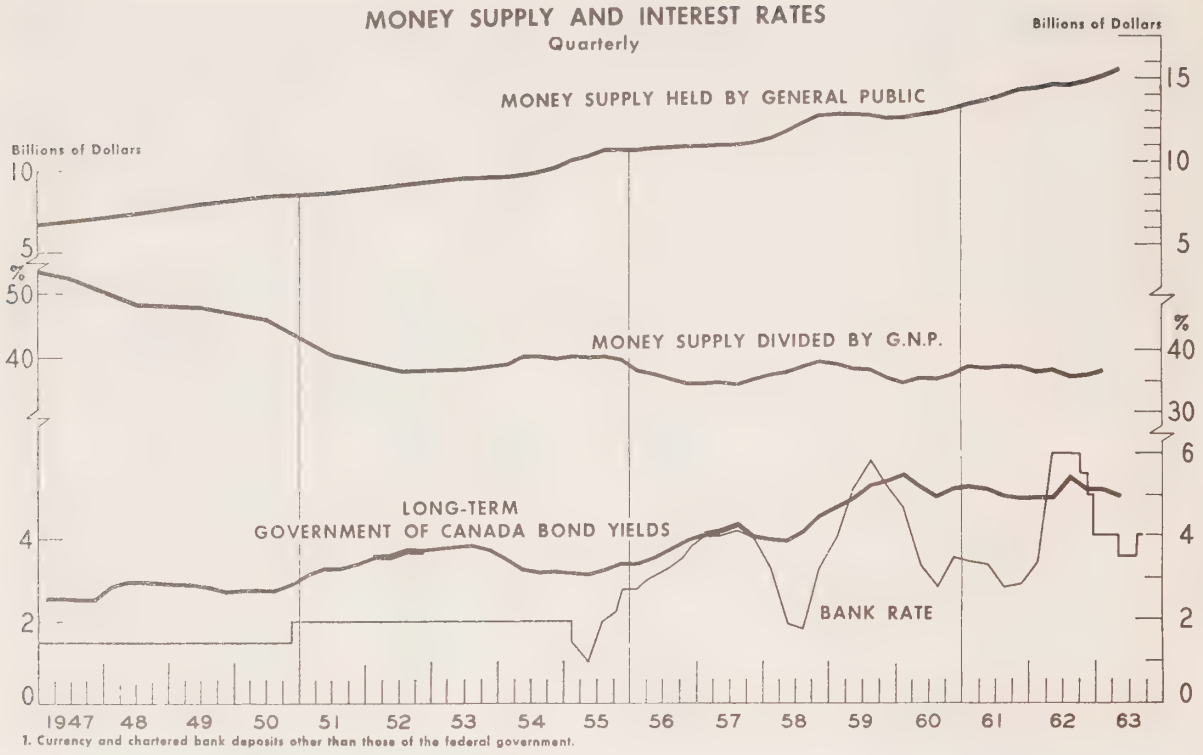


Recession phases of Canadian cycles are shaded

the possibility of using fiscal surpluses to combat inflationary pressures, monetary policy began to be used more actively around the world. In Canada, monetary restraint was applied from late 1950 onwards, bank rate was raised, and the banks were asked to curb their lending activities. Rates on 15-year Canada bonds reached a peak of 3¾% in late 1953, but with the onset of the first real post-war decline in production, a very easy policy was pursued. While this recession turned out to be neither particularly severe nor especially prolonged, it raised considerable concern in the minds of the public and the monetary authorities. The latter persisted in a policy of ease well into 1955 when the investment boom was already well under way. The money supply was increased substantially, bank rate was actually lowered in February of 1955, and rates on many short-term Canadian bonds were below those in the United States. Credit conditions were subsequently tightened to try to restrain the developing pressure on resources and bank rate was raised a number of times until in November 1956 it was set at a rate ¼ of 1% above the weekly average tender price of 91 day treasury bills. It was in this interval also that the 15% liquid asset ratio arrangement was entered into with the banks, attempts were made to curb sales

75319—27½

Chart 20-8



1. Currency and chartered bank deposits other than those of the federal government.

finance company activities, and the banks were urged to curtail term and other specified types of lending.

Conditions were subsequently eased in the latter part of 1957 and the money supply expanded significantly into the following year, in large part because of debt management operations to be referred to later. Mindful that they had been too easy and too late in restraining the 1955-57 boom, aware of the difficulties stemming from the high liquidity created in 1954, and influenced by continuing price increases and fears of inflation, the monetary authorities in late 1958 virtually froze the money supply despite the fact that the recovery then underway was only in its early stages and had shown few signs of strength. The resulting credit tightness, widespread fears of inflation in financial markets, and apprehension about the size of the government's deficit combined to drive interest rates to record levels. No doubt rates would have been higher than they were in the early post-war period under virtually any policy in view of inflationary expectations and the relatively more intense world demand for capital. However, this policy of vigorous restraint contributed to the fact that the 1958-60 expansion was the weakest since the end of the war and the only one which fell short of the corresponding American recovery. The widening interest differential between Canada and the United States in 1959-60 attracted additional external capital, kept the premium on our dollar higher than it otherwise would have been, and thus contributed to the deterioration in our international current account position. Yet the authorities, apparently influenced by the failure of easier conditions to bring down the exchange rate quickly in the 1954 recession, seemed to believe at this time that their credit policy was not a significant factor in keeping the exchange rate too high.

Following rejection by the Minister of Finance of some of the tenders for treasury bills in August

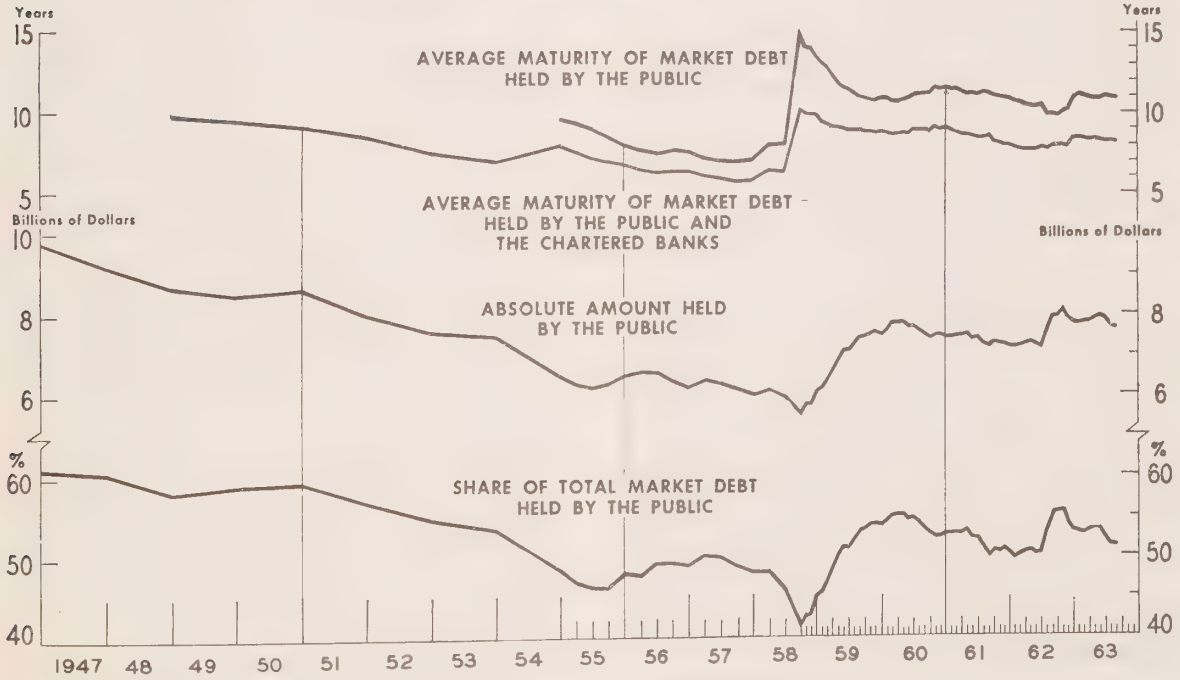
1959 conditions eased, although the money supply did not begin expanding again until well into 1960, after the next recession had started. This easier trend was continued, because of the weak nature of the following recovery, until the restraint dictated by our weakening international position was imposed in the middle of 1962. As mentioned earlier, this need proved short-lived and bank rate, which had been raised to 6% in June and restored to a fixed basis, was lowered in successive stages in late 1962 and early 1963 to 3½% and subsequently raised to 4%. Meanwhile the money supply was allowed to expand further so that relatively easy credit conditions would stimulate domestic activity and avoid attracting excessive amounts of international capital and reserves.

Debt management policy is closely related to monetary policy in that both influence credit conditions and thus the level of spending in the economy. If debt management policy is being used as a contra-cyclical weapon, in conjunction with other policies, one might expect a reduction in the maturity of the debt in the hands of non-government holders when an easing in credit conditions is desired and a lengthening in opposite circumstances.[10] The proportion of debt in the hands of the non-banking public—and in certain circumstances even its absolute amount—may also need to be reduced to ease credit conditions and encourage spending on real goods and services, while the reverse may be true when restraint is sought. Chart 20-9, which shows the relevant data, indicates that such a pattern has not been very closely followed in the post-war period. In the early years, the support given to government bonds encouraged their liquidation by the public, contributed to maintaining excessively easy credit conditions, and stimulated spending at a time when restraint would have been more appropriate.

[10] The various principles on which the debt may be managed are discussed in Chapter 22.

Chart 20-9

AVERAGE MATURITY OF THE FEDERAL DEBT AND HOLDINGS OF THE PUBLIC [1]



1. The "public" is used to mean all holders other than Bank of Canada, Government Accounts and the Chartered Banks.

This episode illustrates how pursuit of an inappropriate subsidiary goal, in those circumstances the maintenance of unduly low interest rates, can in fact undermine the achievement of major goals: for the sake of stabilizing the price of capital the entire economy suffered additional inflation and a further weakening in its competitive position which contributed to subsequent high levels of unemployment.

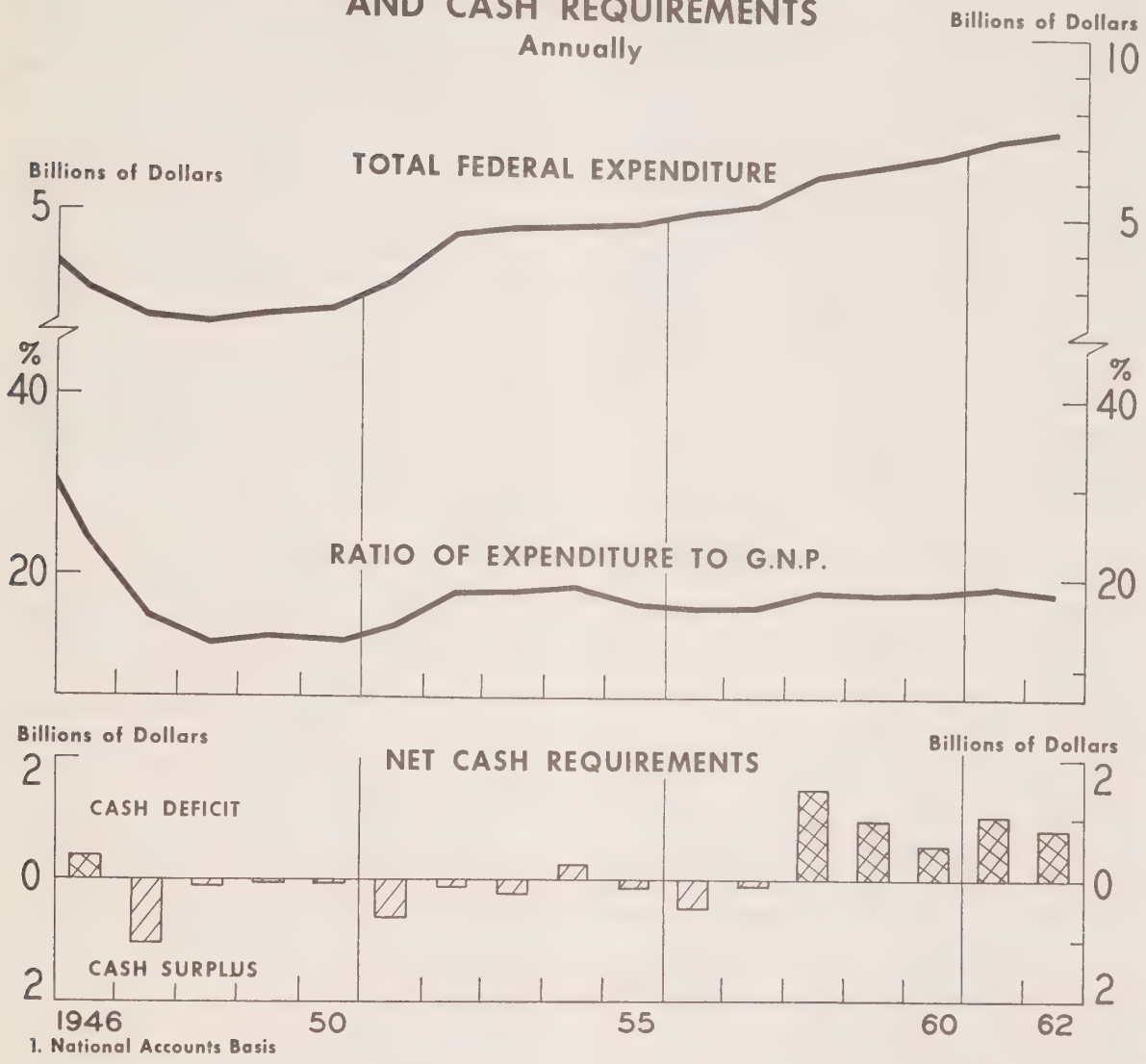
When this policy was abandoned in 1950 in order to free monetary policy to combat the renewed inflationary pressure then threatening, no real efforts were made to lengthen the term of the debt or to encourage the non-bank public even to maintain its share of the total outstanding. However, in the recession year 1954 the term was lengthened by the issue of several long maturities even though the monetary authorities were pursuing a policy of ease, while in 1955 and 1956, despite the restrictive measures being used to combat the investment boom, the term of the debt held outside the government sector shortened. This process continued well into 1957 but was reversed in the following recession by the issue of several long-term maturities. These efforts were, however, dwarfed by the huge Conversion Loan of July-September 1958 which at one step lengthened the maturity date of over 40% of the outstanding marketable debt and extended the average maturity of the public's holdings by almost 7 years to 14 years 9 months. Despite the variations in the level of economic activity since that time, the only exceptions to a process of continuous shortening of the debt in the public's hands have been 1960 (a recession year) and late 1962 and early 1963 when international considerations predominated. The amount of bonds held by the non-banking public was allowed to run down in the 1960 recession and the early part of the recovery which began in 1961 but rose sharply because of the measures taken in 1962. In general, then, debt management policy has been more oriented to the narrower, but still important, objectives of minimizing the government's costs and—to some extent—keeping security markets orderly than to broader national goals.

Fiscal policy has been used only infrequently during the post-war period as a deliberate stabilizing instrument, although a powerful stabilizing force has been provided by automatic changes in the federal surplus or deficit as underlying economic conditions have altered. We have shown federal expenditures on a national account basis on Chart 20-10, both absolutely and as a proportion of total national expenditures, while the bars at the bottom of the chart show the government's net cash requirements including those needed for loans and investments. Government expenditures were sharply reduced from their war-time level during 1946 and the proportion of national resources claimed by government fell sharply in 1947 and 1948 as was desirable during an inflationary period. Moderate cash surpluses emerged, (the large figure in 1947 was in substantial measure due to the decline in exchange reserves) although these appear to have been to some degree an accidental result of more buoyant prices and activity than had been forecast. In any event, their usefulness in drawing funds from the income stream at a time of strain on resources was undermined by monetary policies and by debt management techniques which made it particularly easy for the public to exchange its bond holdings for cash. Taxes were cut in the 1949 recession, but the government's surplus fell only moderately. However, as in all the post-war recessions, its share of national expenditures rose somewhat, thereby giving support to the level of economic activity. In late 1950 and early 1951, substantial additional taxes were imposed to finance the higher defence expenditures made necessary by the Korean War, although these expenditures did not reach a peak until 1952. A substantial surplus consequently developed in 1951 and made some contribution—along with monetary policy—to restraining demand. Other measures introduced in this period included consumer credit controls, accelerated depreciation for defence and defence-supporting investment, and the withdrawal of depreciation privileges on certain non-essential building. Price controls were

Chart 20-10

FEDERAL GOVERNMENT EXPENDITURE [1] AND CASH REQUIREMENTS

Annually



1. National Accounts Basis

considered following their temporary imposition in the United States but were rejected in favour of the more general instruments which were easier to administer and less damaging to efficiency. Foreign exchange controls were not needed and in any event were not favoured in view of the shelter that the earlier measures had provided to high-cost industries.

In 1953, personal income taxes were reduced to approximately their 1950 levels, but no significant deliberate measures were taken in the 1954 budget to combat the recession, and government expenditures in fact showed their smallest post-war increase. However, changes in the budgetary and cash position occurred and this, together with the introduction of the National Housing Act,

provided some support to the economy; most of the burden of stimulating the economy, nevertheless, was carried by the monetary authorities. Further modest tax reductions were made in 1955 and in spite of the fact that capital investment reached a peak of over 27% of national production two years later, no deliberate fiscal measures were taken to damp down demand in this period. Indeed, federal policy added to the strain on resources coming from the investment boom in metals, oil and gas, and manufacturing by proceeding at unreduced speed with such projects as the St. Lawrence Seaway and by financing part of the cost of a privately-owned pipeline. The automatic effect of buoyant revenues, however, turned the modest government deficit of 1954 into a surplus of about $500 million in 1956. Monetary restraint was virtually the only discretionary policy weapon used—debt management, as we have seen, was easing credit conditions in this period. Although the next recession began in April of 1957, only minor adjustments were made to taxes, and expenditures as a proportion of national production remained well below that of 1954.

The new government took substantial steps to stimulate the economy in the latter part of 1957. Payments to pensioners and to the provinces were increased, taxes were cut, the winter works program instituted, and substantial direct mortgage lending begun. Government expenditures consequently rose sharply in the next year, both absolutely and as a percentage of national production, while the approximate cash balance of the latter part of 1957 was replaced by a net requirement of almost $1.5 billion. On a national accounts basis, the deficit was about half as much, in part because the cash requirements included loans of over $300 million to CMHC for mortgage lending: excluding these transactions the cash requirement was equal to a little over 3% of G.N.P. Apparently in the belief that the 1958-59 recovery was going to be vigorous and out of concern about prevailing inflationary fears, taxes were raised somewhat in 1959—a measure which, with monetary restraint, contributed to the weakness of that expansion. In 1960, some tax incentives were given for production of new products but no major changes were made to counteract weaker economic conditions. In December, however, CMHC direct lending (which had been drastically curtailed) was expanded, the maximum mortgage loan was raised, the winter works program expanded, and measures taken to encourage small business. As a result of these expanded outlays and higher expenditures on vocational training, sewerage, and other projects, government outlays rose more sharply in 1961. This increase was curtailed somewhat in 1962 by the measures necessary to deal with the exchange crisis.

On balance, it is difficult to avoid the conclusion that financial policies in the post-war period have not made the contribution that they might to the attainment of our major economic goals. Quite apart from the inherent limitations of such policies and the difficulties of accurately predicting economic developments, there have been occasions when the instruments of policy seemed to be working against each other or when bolder measures could have been taken in the light of the evidence then in hand. Recessions in the post-war period in Canada as elsewhere have indeed been shorter and milder than those of earlier days, in part because of a lesser dependence on agricultural production but mainly because of the powerful role played by the automatic stabilizers and of more deliberate government policies. Nevertheless, as the following table shows, the performance of our economy since 1957, measured by unemployment and output gains, has been below that of most of the leading industrial countries outside North America even though prices have been more stable.

While Canada's close economic and geographic links with the United States will continue to make it difficult to outperform that economy in a significant way, and while world developments will always have a profound influence on domestic activity, there is no inherent reason why our relative economic performance cannot be improved. A decline in the relative importance of imports normally acts as a built-in cushion against recessions in the same way as their expansion

TABLE 20-2

	Unemployment Rates[a]	Growth of Industrial Production[b]	Price Increases[c]
	1960	*1957–62*	*1957–62*
Canada	7.0%	21.8%	7.1%
United States	5.6	18.7	7.1
Italy	4.3	24.7	13.0
Great Britain	2.4	10.9	11.2
France	1.9	30.2	30.4
Sweden	1.5	23.5	16.5
Japan	1.1	96.1[d]	21.6
Germany	1.0	41.2	10.1

[a]Adjusted to United States definitions.
[b]1957 Average to December 1962—I.M.F. Statistics.
[c]December to December—I.M.F. Statistics.
[d]Manufacturing production.

provides a safety valve when resources are strained. If policies are sensible and close attention is paid to competitive factors, the record indicates that it is by no means impossible to come closer to attaining major economic objectives. To the extent that world concern over growth rates leads to improved international co-operation and co-ordination in this field, the possibilities of achieving these goals will be even greater.

CONFLICTS AMONG OBJECTIVES

If there are inherent and irreconcilable conflicts among the economic objectives of society, one or more of them must be sacrificed or modified. Indeed, even if there were only one objective of economic policy, say to bring unemployment levels below 2%, it would not necessarily follow that it could be reconciled with the facts of our economic life. While all policy measures would be directed solely to achieving this one aim, there would still be difficulties in forecasting both economic events and the effects of policy on them. Moreover, these measures might prove to be self-defeating if they led to rising prices or balance of payments difficulties which impaired domestic and international confidence and curtailed activity. The aims and administration of policy become even more complex when more than a single goal is involved. It is a rare occurrence when the structure of our economy and the nature of policies are such that the pursuit of one objective leads automatically to the achievement of another: one policy instrument is unlikely to prove enough to ensure that we reach all our objectives, while numerous instruments are virtually never so independent in their effects that each can be operated in isolation and all can be aimed at separate objectives.

Nevertheless, there appears to be nothing in the record of Canada or other countries to support the view that the objective of rising productivity is incompatible with high levels of employment, price stability, and a sound external financial position. Although short-run gains in productivity and employment are normally greatest when the economy is recovering from a recession and its resources are being used more fully and efficiently, this is a once-for-all phenomenon and does not alter the fact that rapid and lasting long-run productivity gains have occurred at times of both low and high unemployment. While relatively slow expansions in output per worker are often accompanied by satisfactory employment levels, we see no reason why full employment and long-run productivity increases should be incompatible as long as conditions remain competitive and the general economic climate is kept favourable to work, enterprise and investment. The record also indicates that productivity and growth in Canada or elsewhere are not closely related to specific price trends: vigorous growth, measured in total as well as per employee, has occurred in times of falling, stable, and rising prices while stagnation has also been experienced in comparable circumstances. Finally, satisfactory increases in Canadian productivity do not seem to be in fundamental conflict with the objective of maintaining a healthy economic relationship to the rest of the world, provided that overall activity does not become so excessive as to strain our resources unduly, that prices and costs do not get out of line and that foreign capital is not attracted into unsound projects; external difficulties indeed seem to have occurred

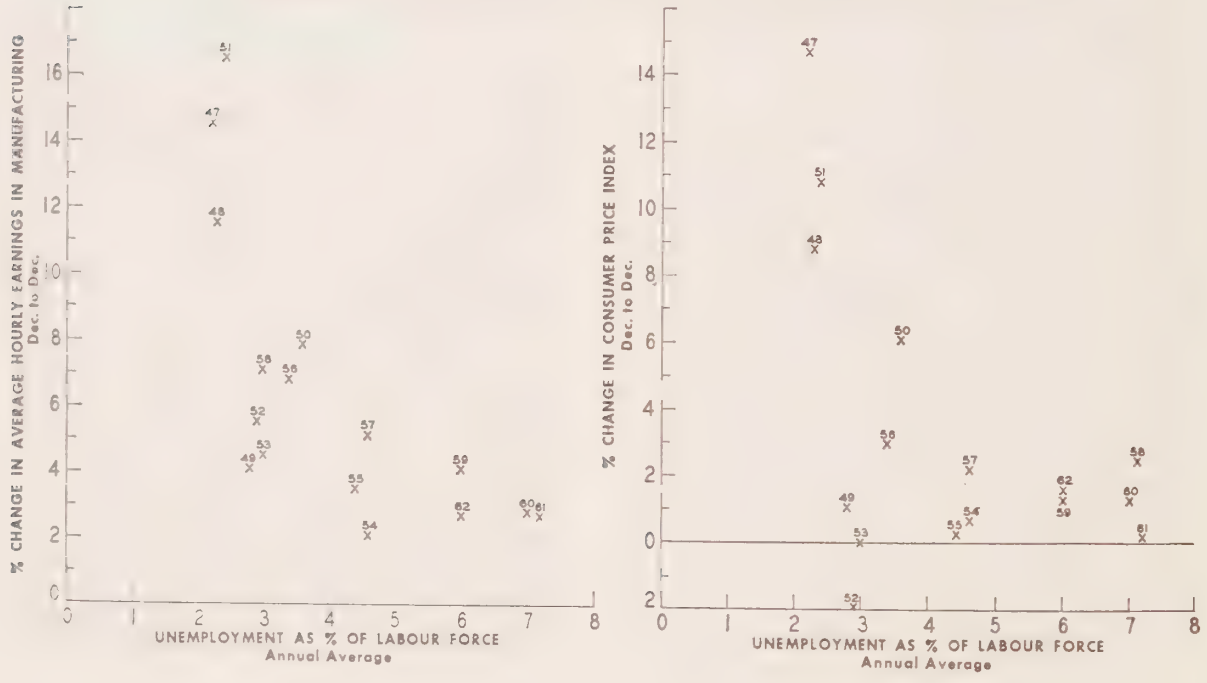
at least as often in times of slow productivity gains in Canada. There may well be times in the future, as there have in the past, when long-run measures to improve the economy's productivity must give way temporarily to considerations connected with the price, employment, or international objectives, but our main point is that there need be no lasting clash between satisfactory productivity increases and these other goals.

The evidence we have studied indicates that the likelihood of conflict between the goals of full employment and absolute price stability is much greater than that between productivity and the other goals, at least in the short run. The conflict is not necessarily severe, but wages and prices do tend to rise at a more rapid rate when demand is strong and unemployment low than when bidding for labour is less intense and competitive conditions make it more difficult to pass higher prices on to the consumer. There is, of course, always a tendency for management, labour, and other factors of production to try collectively to take more than 100% out of the available proceeds of production: the attempt to do so, indeed, imparts much of the drive to expand production and increase efficiency. However, our staff studies did not find that this process was particularly pronounced in highly-unionized sectors of the economy or in industries where prices are dominated by relatively few companies. In fact, we are not particularly impressed with the usefulness of drawing a distinction between "cost-push" and "demand-pull" inflation: if management or labour were in reality free to push up prices and costs without regard to demand and competitive considerations, price increases in Canada would not long have remained as moderate as they have in recent years.

Chart 20-11, which compares unemployment rates with price increases in the post-war period, shows that—apart from the inflationary years immediately after the war and the abnormal increases associated with the Korean War—the conflict between the price and employment objectives

Chart 20-11

RELATIONSHIP OF UNEMPLOYMENT TO CHANGES IN LABOUR COSTS AND PRICES



has been moderate in the sense that there have been only three other years in which price increases have exceeded 2% annually. These were the boom year of 1956, when investment demand was extraordinarily high, and the two years following it: the evidence suggests that the price increases in 1957 and 1958, in addition to being influenced by fortuitous advances in food prices, were the delayed reaction at the retail level and in the service industries to earlier pressures elsewhere in the economy. Because consumer prices tend to lag behind employment and other economic trends, the absence of upward movements in the early stages of a boom does not necessarily mean that inflationary pressures are absent: conversely, increases during a recession may be nothing more than a reflection of past events and thus not a reliable guide to current policy. Nevertheless, it is quite likely to require ingenuity to reconcile the price and employment goals as unemployment falls below the range of 4% to 5%, although the record—and our staff studies—suggest that prices are not noticeably affected by unemployment rates above this range. In any event, much depends on government policies, the restraint and wisdom of labour and management, and the disciplines imposed by international competition. Although it is difficult to reconcile high employment and price stability, there is certainly no rigid and unchanging relationship between the two and no inevitability about price increases at satisfactory levels of employment. The social and economic gains to be realized from reducing unemployment justify putting heavy emphasis on this goal and on the search for solutions to the related problem of reconciling it with price stability.

We have already indicated that continuing and pronounced price increases may lead to higher unemployment, instability and an impaired rate of productivity increase by undermining business confidence, the willingness to save, and our international financial position. Although it is sometimes argued that rising prices are necessary to stimulate business enterprise and induce labour to move into more productive occupations, we see no reason why stable prices should impair incentives—particularly since rising productivity makes such stability compatible with annual average wage increases in excess of 2%. In any event, if significant price increases come to be anticipated—and they soon would be if they continued year after year—inflation would have no stimulating effect: it would divert resources from productive uses, raise interest rates, encourage inefficiency, and might lead to severe international complications. While inflation is unlikely to accelerate markedly unless the monetary authorities permit it to do so, it is like a drug whose dose must be continually increased to get the same effect: if the authorities permitted the economy to become addicted, the inevitable return to reality would bring about very painful withdrawal adjustments.

Assuming that our domestic price, employment, and productivity objectives are being reasonably well met, there need be no continuing or complex conflicts with the international goal as long as developments in the rest of the world are not basically unfavourable. There will, however, probably be shorter-term conflicts arising from developments at home or abroad, in which domestic considerations must give way temporarily to the requirements of the international situation: the 1962 episode is a relevant example. Such conflicts are unlikely to prove lasting if the domestic economy is soundly-managed and competitive. Nevertheless, the problems of the policy-makers are likely to be proportional to the emphasis put upon more specific international aims; for example, if it is considered desirable on political grounds to take action to discourage such foreign capital as contributes to national growth and development, Canadians must be prepared not only to accept a lower rate of expansion, but also to encounter other problems with our international financial position.

The major domestic goals are most likely to come into deep-seated and more persistent conflict with the international objective if world demand or prices for Canadian exports change fundamentally, if there are continuing inflationary or deflationary developments in the main trading countries, particularly the United States, or if weaknesses in international currency arrange-

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ments restrict trade and limit the scope of domestic financial policy. In extreme circumstances of this sort, it might well be necessary to alter the foreign exchange value of the currency, but this would probably shield Canada only imperfectly from unfavourable events elsewhere.[11] If the exchange rate were not altered in such basically-changed conditions, Canada would be unnecessarily sacrificing domestic objectives merely for the sake of stabilizing an unrealistic external value. Even with such changes in the currency, the international limitations on maintaining a satisfactory level of activity and growth when the rest of the world was failing to do so would be real and pronounced. It is therefore very much in the country's long-run interest to see that co-operative efforts are made to avoid both world stagnation and international inflation.

While we believe that the four major objectives are not fundamentally incompatible, it is only realistic to recognize that the policy-makers may be confronted with some awkward choices in the day-to-day environment in which decisions must actually be made. This is particularly the case when the goal of low levels of unemployment must be set against price stability or when shorter-term international considerations conflict with domestic goals. In such circumstances, two broad avenues are open to the authorities: to scale down or temporarily abandon one or more of the objectives—for example, by being prepared to accept higher unemployment levels or forego price stability for a limited period—or to improve or extend the policy instruments at their disposal. In the very short run, only the first course may be open, in which case the priorities assigned to the different objectives should reflect a careful consideration of the costs and benefits of abandoning or modifying each goal. These in turn will vary with what the public believes to be acceptable and desirable, with the particular circumstances of the time, and with the record of the recent past. Thus, if Canada has experienced a prolonged period of inflation more weight should be given to this objective than if prices have been stable or falling, while if unemployment has been unduly high it should receive greater priority. The longer is the period in which results have fallen short of an objective, the greater is the failure and the more likely it is to inflict lasting damage on the structure of the economy: prolonged unemployment tends to make a worker's skills obsolete and undermine his confidence—quite apart from the hardship it inflicts—continuous price increases damage the prospects of maintaining full employment on a sustainable basis, and long periods of slow growth in productivity impair the country's international competitive position.

Since policy combinations always involve choice, virtually never are without their drawbacks and usually must be applied to a changing environment, we can offer no immutable formula by which the authorities should be guided. We do, however, wish to stress the importance of making as careful a calculation as possible of the costs and benefits of following one course rather than another, having in mind their longer-term effects. We have shown, for example, that good and freely-functioning capital markets, although not ends in themselves, can make a worthwhile contribution to efficiency and growth: it would clearly make little sense to inflict lasting damage on these markets only to achieve a short-run gain in terms of, say, exchange reserves or reduced foreign investment in Canada. The "trade-offs" between objectives —the costs and benefits of pursuing one goal at the expense of another—can never be measured only in economic terms because they involve political and social considerations as well. Studies on the economic trade-offs were carried out by our staff based on certain relationships found to exist in the 1949-61 period, but—quite apart from the difficulty of measuring underlying relationships in this way—the trade-offs are not unchanging, being affected both by the structure of the economy and by the nature of policy. The cost of maintaining a sound external position depends in large part on foreign confidence in our domestic policies and on price, employment, and productivity trends abroad in

[11] See Chapter 23 for a fuller discussion of this and related subjects.

relation to those in Canada. Similarly, the price paid for full employment in terms of inflationary pressures is related to the attitudes of labour and management, the competitive environment generally, the speed of reaction of those involved, the tax structure, the mix of financial and other policies being followed, and a host of other continually shifting factors. The benefits or costs of inflation in terms of productivity and growth can likewise be estimated only after taking into account an extremely wide range of considerations.

In urging the authorities to take careful account of both the immediate and more lasting consequences of their actions, we want to stress that this cannot be done wholly or even largely in quantitative terms. Some of the variables involved cannot indeed be measured in such terms and none of them can be properly understood if viewed only as rigid mathematical relationships. Yet it is worth noting that if unemployment had averaged 4½% in 1962 instead of its actual figure of 5.9%, the nation's output would have been at least $600 million higher than it was, on the conservative assumption that the production of the additional employed would have been the same as that of those already at work; a similar calculation for 1961 yields a result of over $1 billion. These calculations are rough and mechanical and make no allowance for the additional productivity of those already at work which would have been brought about by fuller use of capacity. Nor do they allow for any extra output that might have been realized through more buoyant conditions attracting additional immigrants and inducing those not in the labour force to become employed. It is worth noting that a 1.4% reduction in unemployment from late 1961 to early 1963, by no means a period of extreme expansion, was accompanied by a gain of about $2 billion in real national output. Magnitudes such as this help to illustrate the gains which higher employment levels can bring, especially if they can be attained without imperilling the other objectives.

The second alternative open to the authorities when faced with conflicts between objectives is to make policy more useful by improving the timing and effectiveness of existing instruments, by co-ordinating and balancing differing policies better, and—if necessary—by adding to the range of measures used. While we will deal with these matters in succeeding chapters, we believe that this approach offers considerable scope for improving the nation's economic performance and for reducing or eliminating the incompatibilities among our major goals. As already noted, the record indicates both that existing measures have not always been fully or wisely used and that the meshing together of fiscal, monetary and other policies in the post-war period has by no means been consistent or complete. Moreover, as many of our foreign witnesses pointed out, some of the apparent conflicts among objectives and policy failures arise from trying to solve by monetary measures problems which cannot be solved by such means. Thus, heavy responsibility for reconciling the employment and price objectives has been put on central bank policies which, while essential to help bring about the right climate of demand, are too general to attack some of the specific imperfections which give rise to much of the problem. In such cases, conflicts between objectives or failure to attain our goals, can only be remedied by using measures which go to the root of the difficulties—for example, by up-grading the skills and increasing the mobility of the labour force so that it is more responsive to changed conditions, by ironing out imperfections and competitive weaknesses in the markets for goods and services, by encouraging management to be more aggressive and efficient in export and domestic markets, and, if necessary, by ensuring that the public interest is protected in the collective bargaining process. Nevertheless, little can be accomplished by such measures if the general set of financial policy—including both monetary and fiscal policy—is not properly geared to create the right general climate and an appropriate aggregate level of demand in the economy.

The number of such policy instruments which may have to be used will depend on the nature and complexity of the problem in hand and on the influence of each instrument on the economy

at that time. Although a wide variety of measures may be required, we believe that if a co-ordinated approach is followed there is a good possibility of reconciling relatively low levels of unemployment with price stability. Similarly, the full growth potential of the economy will only be realized if appropriate monetary and fiscal policies are combined with measures to develop the economy's skills and levels of education, to encourage saving, investment and risk-taking, and to ensure that production is organized efficiently.

The entire range of society's economic goals is an elaborate and extensive one, is never static and cannot be precisely spelled out. It involves continuing compromise to blend the many special and conflicting political, social and economic concerns of various segments of the community into a program which is generally acceptable to the nation as a whole. Unbalanced attention to one objective, or to subsidiary aims, is bound to impair performance, and we have, therefore, concentrated our attention on the possibility of attaining the four major economic objectives which we believe command general support. While luck and the world economic climate will of course continue to exercise a major influence on how successful the nation is in attaining its goals, we believe that skill, imagination and leadership will play an important role in determining the outcome.

CHAPTER 21

THE EFFECT OF CREDIT CONDITIONS ON EXPENDITURE

Even if Canadians were to achieve unanimity on the ends which financial policies should serve, it would be difficult for them to agree on the means of promoting these objectives. A part of this disagreement stems from uncertainty about the effectiveness or equity of various financial measures, and we accordingly deal in this chapter with the results of the studies and surveys by which we attempted to measure the response of spending on real goods and services in the economy to changes in monetary and debt policies. Our concern is with expenditures in real terms—on consumption and physical investment —not financial transactions, since it is these expenditures that the authorities seek to influence with the aim of helping to achieve a level of economic activity compatible with our national goals.

There are a host of relationships between monetary and debt policies and spending decisions, and there are several different viewpoints from which these relationships can be examined. One such view tends to put considerable emphasis on the supply of money and stresses the broad parallelism between the stock of money and such variables as consumer spending and economic activity generally, price levels, and interest rates. A second approach lays stress on the supply of a broader range of financial assets than those which qualify as "money", on the grounds that no sharp distinction can be drawn between chartered bank deposits and their close substitutes—the deposits of competing institutions, savings bonds and (for large investors) money market paper. Proponents of this view thus see a powerful connection between spending decisions and the supplies of a broad range of liquid assets.

We have, however, found it more useful to think in terms of *how* operations on the part of the authorities influence spending decisions rather than in terms of a mechanical relationship between economic activity and some specified quantity of financial assets. We have therefore taken a more comprehensive approach, which seeks to explain the influence of the authorities over real expenditure in the economy in terms of "credit conditions"—i.e. the cost, terms and general availability of credit to borrowers and, consequently, the terms and yields on which savers may invest their funds. We emphasize that this is not a radical departure from the position taken in much current discussion of monetary policy and is indeed the framework developed in the Bank of Canada's submission to us.

If credit markets were perfect, the state of credit conditions would be indicated by the level of interest rates alone. In fact, of course, there are legal, institutional and other rigidities in the system, and interest rates by themselves sometimes fail to reflect fully the ease or difficulty of obtaining credit; for example, they do not always mirror changes in the speed with which credit applications are processed, alterations in the amounts that will be lent to a given borrower, or variations in the terms and conditions demanded by lenders. Nor is there a single rate to which one can look

for indications of general credit conditions: there are many types of lender—each having slightly different investment objectives—and many classes of borrower, varying as to credit-worthiness, as to the collateral they offer and as to the amount, term and other features of their loan requirements. Thus when we talk about credit conditions generally, we are talking about the state of a variety of borrowing and lending markets rather than about a single central market in credit.

However, we have emphasized that—despite their imperfections and differences—financial markets are closely inter-related. Thus, there is a tendency for changes at the centre of the system to spread fairly quickly to the rest of it; the speed and completeness of this transmission process has indeed become greater in recent years with the development of improved markets, the increased overlapping of functions between institutions, and the heightened sophistication of participants in the capital markets generally. Changes in market rates and yields thus usually give a broadly accurate picture of the state of credit conditions, particularly in the interest-sensitive money and bond markets, although these rates may not all move together when the change in conditions is not a decisive one; short rates, for example, may lead long rates, and corporate yields may respond faster than those on government obligations. Some rates which are more rigid for legal or institutional reasons, including those on bank loans, on mortgages made by some lenders and on government lending programs, give a less accurate reflection of underlying availability since a greater or lesser degree of rationing may be occurring. Thus, one has to look at other data as well—the banks' liquid position, their lending policy and other indications—to obtain a better picture of changes in credit conditions. Although it is therefore only rarely that one can identify the exact point in time at which general credit conditions can be said to have altered, the broad changes are nevertheless clearly written on the record.

We have used the credit conditions approach in attempting to analyse the impact of monetary and debt policies on spending because it allows one to take a comprehensive view of the financial considerations influencing spending. The links between financial conditions and spending can only be understood by looking directly at the situation facing spenders. Governments, businesses and individuals who wish to increase their spending can only do so (assuming their incomes do not rise) by reducing their rate of current saving in the form of financial assets, by borrowing, or by disposing of real or financial assets accumulated out of past income. As the Bank of Canada puts it: "Each of these methods of financing involves an impairment of the spender's position compared with what it might otherwise have been. Every spender must continually weigh the attractions and advantages of an increase in spending against the risks, difficulties and disadvantages involved in financing it . . ."[1] When credit conditions become less restrictive, funds become easier and cheaper to obtain—either by borrowing or by selling existing holdings of financial assets—and those considering new expenditures will feel less inhibited by the financial consequences of proceeding with their plans. Thus, some spending projects which were not profitable at higher levels of interest rates, or for which funds were not previously available, will be proceeded with. At the same time, those who might formerly have abstained from real spending because of the high yields obtainable on financial assets will have less incentive to do so and will tend to increase their expenditure on real goods and services. Moreover, both potential borrowers and savers may be encouraged to increase their spending by changes in their expectations about the future cost and availability of funds and in the climate of opinion generally. Incomes will rise and these higher incomes will in turn enable those receiving them to increase their spending and generate additional incomes and expenditures elsewhere in the economy. In short, it is the whole range of credit conditions—i.e. the difficulties, costs and risks of borrowing and the attractions of acquiring and holding financial assets—which

[1] Submission II, paragraph 12.

is the link between financial markets and real expenditure.

Obviously, the supply of money, and of other liquid assets, is an important factor in explaining the state of credit conditions since this will influence the terms on which the means of payment are available to spenders. However, changes in the money supply are only one of the influences bearing on credit conditions and thus on spending. They may indeed be the dominant influence at any point in time, as is true for example when massive changes in the money supply take place. Large changes in the quantity of other categories of financial assets can also influence credit conditions significantly: the huge increase in the outstanding long-term government debt at the time of the 1958 Conversion Loan for example, contributed to the subsequent sharp rise in interest rates by lowering the public's holdings of more liquid assets (short-term Victory Bonds) and causing them to require high returns for parting with investible funds. However, other influences are also important, including changes in underlying public attitudes towards spending and saving, alterations in the profitability of physical investment—whether stemming from technological change or changes in the economic climate at home and abroad—shifts in fundamental investor preferences and expectations, and many other factors.

Nevertheless, as we indicated in Chapter 6, the main technique by which the authorities have influenced credit conditions since the unpegging of the bond markets in 1950 has been through altering the cash reserves of the banking system, and hence the "money supply". Yet, as the Bank of Canada has told us, it does not conduct these operations because it has a precise view about the appropriate quantity of money at any point in time; they are carried out as a means of influencing credit conditions.[2]

If the authorities wish to stimulate the economy, they will induce the deposit-taking institutions to expand their assets. The initial effect will be to change the form, but not necessarily the total, of the public's financial assets; instead of holding corporate securities or government bonds, they now hold deposits while the deposit institutions have added to their loans and bond holdings. The public's holdings are now more liquid and less risky, and this enhanced liquidity will be associated with lower interest rates, easier conditions in financial markets generally and greater inducements to spend on real goods and services.[3]

While we will discuss the various ways in which the authorities may influence credit conditions in the next chapter, it is worth noting here that it is difficult to draw a clear distinction between the monetary and debt authorities when discussing policies designed to influence credit conditions. Institutional arrangements vary from country to country, but the operating responsibility for Canadian monetary policy rests with the Bank of Canada, while debt management decisions are in the hands of the government and the Bank's position is that of a market agent and advisor. It is clear, however, that purchases and offsetting sales of securities by the Bank from its own portfolio without net cash reserve consequences have in themselves effects essentially similar to comparable purchases and sales by the government in the management of its debt. The distinction between monetary and debt policies is thus somewhat arbitrary, and when we speak of the authorities we shall be referring to those responsible for monetary and debt policy. This subject, and the related matter of ensuring that the two strands of policy are effectively coordinated to produce the desired effect on credit conditions, will be more fully dealt with later in the report.

The effect of monetary and debt policies on real economic activity of course depends on the ability of the authorities to influence credit conditions as well as on the influence of credit conditions on expenditure. While it is the latter relationship

[2] Submission II, paragraph 48.

[3] This assumes that the public's preferences have not changed. If there had been a precisely equal increase in the public's desire to hold deposits and other liquid assets rather than the direct debt or other less liquid financial assets now being acquired by the institutions, credit conditions and real spending will not have been affected even though the "money supply" has altered.

that we will examine in this chapter, we wish to stress that the authorities must accept a major responsibility for the credit conditions prevailing at any point in time. As the late Sir Dennis Robertson put it:

> "I do not think that the duty of the Central Bank in respect of interest rates, short or even long, can be properly expressed by saying that as far as possible it must leave them to be determined in a free market—it is itself inevitably too much a part of the market for that to make sense; it is its duty to influence the rates in a direction and a degree consistent with the long-term forces operating in the economy".[4]

This view is also accepted by the Bank of Canada, as the following quotation from their submission to us clearly points up:

> "In summary, the job of monetary policy is to assess the nature and impact of all the factors bearing on credit conditions and to decide whether in the circumstances it should allow them to be fully reflected in credit conditions, or whether and to what extent it should try to reinforce or mitigate their effects. In any set of circumstances there are limits to the range within which it is practical for monetary policy to allow or encourage credit conditions to vary, but within the range it can influence credit conditions in the direction appropriate in the circumstances".[5]

This amounts to saying that the central bank must always have a view about the whole state of credit conditions. Moreover, it by implication says that conditions prevailing in financial markets at all times must either have been acquiesced in or encouraged by the authorities and therefore reflect its policy. As the quotation however makes clear, there are limits to the authorities' ability to influence credit conditions. These limits are imposed by the need for public acceptability of credit policies, by international considerations, by the underlying tone of domestic economic activity and by the public's attitudes to saving and investment, as well as by the need to keep financial markets functioning effectively and many other factors. Nevertheless, there is a range—sometimes broad, sometimes narrow—over which the authorities can set the tone of financial markets in order to influence expenditure.

[4] Submission, page 29.

[5] Submission II, paragraph 75.

THE COMMISSION'S RESEARCH ON CREDIT CONDITIONS AND EXPENDITURE

From the beginning of our inquiry, we have felt that an understanding of the extent and timing of the response of the economy to changes in credit conditions was of crucial importance. In the absence of such an understanding it would be impossible to judge either the effectiveness of monetary and debt policies by themselves or the need for supporting them by other instruments of policy. We therefore made a special point of raising this issue with those testifying before us and instructed our staff to carry out a program of empirical research on the question. The facts which are available for study include statistical information on changes in economic magnitudes and the direct experience of participants. The methods which are available for studying these facts can be classified in three categories—economic arithmetic, econometrics, and surveys.

Economic arithmetic—the compilation of statistical information and its analysis by graphical and other elementary techniques—points the way for other methods. If it were not possible to array quantitative information on the level of expenditures for various purposes by various groups in the economy, it would be difficult to begin to assess the effects of policy changes. In general, however, this method has not proved particularly useful in the study of the extent and timing of expenditure changes induced by changing credit conditions. It is easy to see why this is so. If, for example, interest rates and corporate investment are charted, it is found that they often move together. Corporate investment is rising or high when the expected yields on real assets are high, but high investment in turn tends to raise incomes and interest rates, particularly if the

authorities seek to promote economic stability by further tightening credit conditions. This will reduce investment below what it would have been in the absence of a change in credit conditions. But since the expected yields on real productive assets are relatively high in relation to the cost of borrowing at such times, investment will still be higher than it was when profits and business activity were less buoyant. Moreover, other factors will be influencing investment decisions at the same time—changes in technology and markets are constantly occurring and attitudes and confidence frequently shift. Thus the effect of a change in credit conditions by itself will be impossible to detect by a direct study of the data. Although there may be exceptions in the case of some components of expenditure which are at times drastically affected—for example, housing—the use of nothing more than the methods of economic arithmetic often make it quite possible to argue that the effect of a change in credit conditions is zero.

The econometric method of handling the statistical data uses a quantitative analysis for discovering relationships that may be missed by merely looking at tables or charts. There are some who feel that the use of advanced statistical techniques and electronic computers to explore the relationship between one economic variable and others constitutes a "black art" likely to produce misleading results. However, the increasing use of such techniques by business firms and others has made for a wider understanding of the fact that there is no clear dividing line between elementary and advanced statistical techniques. Anyone who is prepared to draw inferences from a relationship revealed by graphical techniques or tabular presentation has no basis for rejecting a relationship revealed by an equation fitted to the same data. In many respects indeed, the econometric technique shares common difficulties with graphical analysis. If, for example, the effects of profits, credit conditions and "capacity utilization" on investment decisions are being separately evaluated, these variables must not move too closely together during the period being examined. If they do, there may not be enough variety in the experience to permit the separate effect of credit conditions to be detected.

The econometric work of this Commission was exploratory and incomplete. We did not attempt to construct an econometric model of the Canadian economy although we did have econometric work carried out on the effects of interest rates and the money supply on the demand for consumer goods and services, for new residential buildings, new capital equipment, new non-residential structures, non-farm business inventories, exports and imports. In many cases econometric analysis failed to reveal effects of credit conditions which our other work suggested should be present in the data. But while the direct results were limited, the precision required for carrying out econometric analysis contributed in an indirect but important way to the improvement of the other empirical work carried out for us.

A third way of attacking the problem is through the direct questioning of decision-makers on the way in which they have responded to changes in credit conditions. There are several problems encountered in the use of this method. First, it may not be possible to question a sufficiently large or representative group of those making decisions. Second, those who make the decisions may not be able to disentangle the effect of credit conditions from other influences affecting their behaviour. Third, some of the indirect effects of changes in credit conditions are not recognized and therefore cannot be measured directly by this method.

The problem of adequate coverage is less serious than it might appear to be. It is true that decisions on consumption are made by literally millions of individuals, and that heavy reliance must be placed on sampling methods. Our consumer survey described in Chapter 2 attempted to shed light on the effect of credit conditions on consumers' decisions. In the case of some other categories of expenditure, however, the decisions are highly concentrated. For example, our analysis of the effects of credit conditions on the capital expenditures of business and government enter-

prises was aided by the fact that around 80 enterprises carried out over $2 billion of the $4 billion of corporate capital expenditures in 1959. Our staff interviewed virtually all of these firms. Of the remaining $2 billion, capital expenditures totalling $1.2 billion were made by 750 firms each having assets over $5 million, 600 of whom completed mail questionnaires and many of whom were interviewed. To cover the remaining $800 million, a mail survey was made of a sample of firms, and interviews were also carried out on a sample basis to determine how the expenditures of smaller corporations, unincorporated business, farmers, fishermen, financial and real estate corporations, builders and private institutions were affected by credit conditions. Members of our staff also interviewed officials of the provincial governments and many of the municipal governments, a number of bank managers, security underwriters and officers of other financial institutions. While the coverage was not complete, the program of interviews was large enough to provide some information on the behaviour of firms and governments in all parts of the country.

THE NATURE OF OUR FINDINGS

There has been no lack of recent experience on which to base findings on the effects of credit conditions on expenditures. In the last decade, there have been three distinct periods of credit ease (1954-55, 1957-58 and 1961-62) and three periods of credit restraint (1956-57, 1958-60 and mid-1962). There have also been other short periods when some components of credit conditions, such as short and long-term interest rates or the availability of mortgage funds, have been subject to temporary fluctuations.

The changes in credit conditions which have occurred during this period have not been small by historical standards. For example, the yields on federal treasury bills have increased from under 1% to over 6% in a period of credit restraint and declined again to just over 1½% in the ensuing period of ease, while the yields on long-term government securities have risen from under 4% to over 5½% in a period of restraint (a swing of over 15 points in price) and declined by .8% in the subsequent period of ease. Other borrowing and lending rates have also shown significant increases and reductions, and there have been major changes in the availability of National Housing Act mortgage funds, bank loans and other forms of credit.

In addition to these short-term variations in credit conditions, there has also been a significant upward movement in interest rates over the course of the last fourteen years. During the first half of 1950, yields on long-term Government of Canada securities were below 3% and yields on provincial, municipal and corporate bonds were on the average between 3% and 3½%. In the period 1959-63, yields on long-term Government of Canada bonds were generally between 5% and 5½% and yields on provincial, municipal and corporate bonds were generally between 5¼% and 6%. Other borrowing and lending rates shifted upward in a similar way. There was, in short, a major long-term change in credit conditions.

The evidence which we have examined on the effects of a change in credit conditions on expenditure derives primarily from short-term rather than long-term changes in credit conditions. Even in the case of short-term changes in credit conditions, the variety of techniques which we have used and the help we have had from all quarters do not give us certain and precise knowledge of the response of the Canadian economy. We have come to the conclusion, however, that in most instances a close study of all the circumstances can establish within useful limits the range of possible effects brought about by such short-run changes. If plans have been altered as a result of a change in credit conditions, it is possible to make a meaningful comparison between what it was intended should be done and what was in fact done. Attempts to measure the impact of a major change in the "gear" of interest rates occurring over an extended period are far less reliable. Consumers, businessmen and those responsible for provincial and municipal spending decisions are necessarily creatures of their environment. While they can indicate how a recent

change in credit conditions has altered their plans, they cannot be at all sure how their plans would have evolved had they been living in a financial climate in which the whole decision-making atmosphere had been different. Thus, for example, a policy of restraint persisted in for some years may dampen demand in ways not directly measurable because projects which might have gone forward in a different set of circumstances are not even considered. Moreover, so many other changes in basic economic forces occur over long periods that no method of analysis can distinguish the particular effects which altered conditions in financial markets might have had on expenditures.

It is true of course that Canada is in no position to pursue monetary and debt policies without regard for what is happening in the rest of the world, so that our latitude to alter the domestic financial environment is limited. Nevertheless, there have been times when the set of our policies might have been significantly different, as in the period 1958-61 when less restraint would have been appropriate.

In view of the range over which monetary and debt policies have been used in the last decade, it would be surprising if there had not been some effects on domestic expenditure. When interest rates have risen and the availability of credit has been curtailed, there has been no lack of public complaint. This suggests that these changes have been widely recognized and, given the vigour of some of the criticism, that in at least some cases credit restraint has had considerable impact. Our findings confirm this view, although the effect of restrictive policies on expenditure has been very much less than the public outcry would lead one to believe.

The relative insensitivity of much of expenditure to changes in credit conditions has not generally arisen from an unawareness of changes in credit conditions among those making decisions. For example, virtually all large non-financial corporations, and a significant proportion of smaller companies, are either borrowers or lenders in the short-term money market and follow market trends closely, while other firms frequently have a portfolio of short-term securities to be managed. Holdings of government and other securities among manufacturing corporations in 1959 were larger than or equal to holdings of cash in all size classes above $250,000 of assets and any change in credit conditions is immediately reflected in the market value of these holdings. Corporations without major holdings of financial assets have connections with banks and other financial institutions and are quickly made aware of any changes in lending policies. Moreover, even though a significant proportion of the funds required for capital expenditure is internally generated, firms frequently turn to outside sources of funds. Of the firms with assets over $90 million, over 80% undertook fresh borrowing of short or long-term funds in the period 1955-62 and among the smaller firms many resorted to bank borrowing.

Our inquiries have also indicated that firms have made rapid and sometimes extensive financial adjustments because of changes in credit conditions. For example, more than 10% of the firms responding to the corporate survey indicated that their accounts receivable became noticeably slower in payment when credit conditions tightened. Similarly, during each of the periods of restraint about 5-10% of the firms surveyed were led to change their sources of finance by finding new lenders, making sale and lease-back arrangements or borrowing abroad. Some were also moved by unfavourable bond market conditions and buoyant stock markets to raise funds through equity issues. The switch to foreign sources of funds was most obvious among the largest 80 firms, 10% of whom borrowed outside Canada in 1959-60—in part because of the rise in interest rates in Canada. Less than 5% of the smaller firms borrowed abroad but these firms were rather more willing to change their sources of finance within the country. However, many small firms made increasing use of foreign trade credit.[6]

[6] See, for example, Transcript page 5315.

Despite these extensive financial adjustments, some businesses—and consumers and governments as well— reduced their planned expenditures because it was more expensive or more difficult to borrow. Similarly, there were cases in which the higher rate of return available on financial assets led to marginal reductions in expenditure through the increased incentives to saving; even in the corporate field some of our respondents indicated that dividend policy was watched carefully in tight conditions in case the funds involved might be needed in future.[7] In short, our findings suggest that most of the effects of credit restraint predicted by theoretical reasoning can be found in the operations of the economic system[8]. It is less easy to find reliable evidence of corresponding effects from an easing of credit conditions in recent Canadian experience, but it may well be that an equally wide assortment of such effects could be uncovered in periods of pronounced credit ease.

Thus, the issue is not whether real expenditure is affected by changes in credit conditions, especially extreme changes. The real question is how large and how rapid are the effects which result from changes in credit conditions of the kinds experienced in recent years. Our conclusion is that, aside from the substantial effects which have on occasion resulted from sharp alterations in the availability of National Housing Act mortgage funds, the domestic effects have been quite limited in the short run. Moreover, while the time taken to implement changes in policy, and for the effects of such changes to affect employment and output, does not necessarily rule out the use of monetary and debt policies to exercise a stabilizing influence over the short run, there are significant lags of this kind which mean that actions taken late in one phase of a short-run fluctuation can easily spill over into the next phase of the cycle when the requirements of stability may call for pressure in the other direction.

Before turning to a more detailed examination of the orders of magnitude of these limited effects and the lags in them, it may be useful to consider the reasons why results of this kind have been found. Corporate investment in plant and equipment is often considered to be an item of expenditure which may be sensitive to changes in credit conditions since it fluctuates over a wide range and those making the decisions are expected to be more sensitive to costs and returns than consumers and governments. At any point of time, business firms have a number of projects involving the construction of plant or purchase of equipment for which there are various anticipated rates of return. Some projects which promise a high rate of return will have priority in the plans for investment, but there must be some projects which are regarded as marginal, and which will no longer be regarded as worthwhile investments if interest costs rise.

In some cases, investment decisions are in fact altered, but there are several reasons why increases in interest rates of the kind we have experienced affect only a strictly limited amount of business investment.[9] First, a high proportion of business investment is financed through retained earnings and depreciation allowances. Although firms might be expected to take increased interest rates into account, and perhaps curtail some projects which fail to provide a rate of return comparable to the improved yield on financial assets, after allowing for the different risks involved, our enquiries indicate that this is very rare. The higher opportunity cost of internal funds is only taken into account in a very informal way, if at all, and the effect on expenditure through this particular channel appears to be small indeed. Perhaps more surprising is that many firms relying on external sources for some of their investment funds do not raise the gross or net rate of return which they require from particular

[7] See also, Transcript pp. 4564-5, Canadian Metal Mining Association.

[8] It has been suggested that an increase in interest rates might lead to a perverse reaction, namely an increase in expenditure. We have found evidence that tightening credit conditions affects the timing of financing and leads to larger-scale borrowing in anticipation of even higher rates. However, we have not found evidence that tightening credit conditions by themselves induce a rise in real expenditure, although such cases might exist.

[9] The results of our corporate survey are set out in detail in the appendix volume.

projects when borrowing rates rise. Even in cases where changes in rates of interest are explicitly considered, the cost of only a quite limited number of projects is sufficiently affected by an increase in interest rates to lead to a decision not to proceed.

The insensitivity of many business firms to changes in interest rates thus stems in part from an unwillingness to calculate the costs and benefits of investment projects sufficiently closely. However, the widespread adoption of better techniques for the evaluation of capital expenditures has had some effect in increasing their responsiveness compared to earlier periods. Yet while the improved methods of evaluating capital projects can array existing information in a more useful form, they cannot provide certain knowledge about the future costs and benefits of these projects. Experience has taught executives that most, and sometimes all, of the quantitative data pertaining to a capital project are subject to wide margins of error. It is therefore felt that the relatively minor cost associated with an increase in the costs of internal or external funds falls well within the margin of error which must be allowed for in any project. On the other hand, if the change in credit conditions is sufficiently dramatic to alter businessmen's expectations of the economic outlook, the effect can be larger. We found very few individual instances of this effect in our examination.

Moreover, much business capital expenditure is on a "must" basis in that the firm has either to improve the quality of the product and reduce production costs or lose its position in the industry. Some of this investment is described as having no measurable rate of return and therefore as being insensitive to any change in interest rates. Even if purely "defensive", such investment is frequently judged to be of such importance to the long-run profitability of the firm that it is unaffected by the small changes in costs arising from higher borrowing rates.

It should be noted also that bond and mortgage interest paid by all non-financial corporations amounts to only about ¼ of 1% of sales and—at $300 million in 1960—was under 10% of pre-tax corporate profits.[10] Although the figure is increased by about half if bank interest is also included, interest rates remain a relatively minor item for corporations in general. Even in the case of some of the highly capital-intensive utilities where it might have been anticipated that the effects of changing interest costs would be particularly significant, great stress was put on the need to meet the demand for services; this demand itself was only marginally affected by changes in credit conditions. In cases where the utilities had greater freedom of action to alter capital expenditures, the fact that the regulatory authorities were prepared to take the cost of funds into account in setting rates tended to reduce the degree of sensitivity.

Another factor contributing to unresponsiveness is the existence of a substantial corporate income tax. Corporate executives frequently point out that the cost of an increase in interest rates is cut in half by the existence of the corporate income tax and its effects are therefore correspondingly reduced. This view has some influence on corporate decisions, although it is sometimes suggested that if corporate after-tax profits are reduced by the full amount of the tax, the relationship between after-tax interest costs and returns is not altered. Such evidence as we have, however, indicates that a significant proportion of the corporate income tax has been passed on by corporations and that the effect of an increase in interest rates is therefore dampened by the existence of a high corporate income tax, although this effect is considerably reduced in the case of smaller firms subject to a lower rate.

These generalizations will probably come as no surprise, since virtually all the research work which has been done on the subject has tended to point in the same direction. Nevertheless, some who accept the view that the cost effect of changes in interest rates is small have held that there is a strong incentive to postpone investment if it is anticipated that interest rates will be lower in the near future. They argue that while a change in the long-term borrowing rate from 5% to 6%

[10] *Taxation Statistics.*

cannot be expected to have a major effect if this higher rate is expected to continue, such a change will have an effect if it is confidently expected that the rate a year hence will again be 5%. The decision to proceed with a 20-year issue with regular repayments of principal and interest at 6% as compared with one a year later at 5% will, for example, increase annual carrying costs by almost 9%; stated another way, it implies a short-term interest cost of close to 15% for the year. We have reproduced in Chapter 24 an analysis by Professor Lundberg of a Swedish investment tax which had an effect of this order, and there seems little question that it exercised a major influence over capital expenditure.

In fact, however, an increase from 5% to 6% in long-term interest rates is most unlikely to occur if it is *generally* expected that a decline to 5% will take place within a year. Moreover, those investors who do firmly hold the view that the increase is temporary need not postpone their investment, they must merely find accommodation to tide them over until long-term interest rates have declined. If the rate they must pay for short-term accommodation is a reasonable one, then there is no reason to postpone the project, and we have found that many firms do indeed respond in this way by altering the timing of their financing in the light of their expectations of future movements in interest rates. Other firms do not attempt to forecast the market and thus implicitly treat each change in their borrowing rate as though it were a permanent change. In either case, the timing of investment spending will be largely unaffected by expectations about the future short-run changes in long-term interest rates. Nevertheless, there are some companies which are aware that they may well be borrowing at the peak of a cycle of long-term interest rates, but either do not have access to short-term finance on a sufficiently large scale or elect not to make use of it, preferring instead to cut back their spending; we found that such cases were, however, relatively rare.

If financial markets were perfect, there would be no need to go beyond an analysis of the effects of interest rates on spending. But in periods of credit restraint, business firms with adequate access to credit in normal times cannot always obtain the funds they require at prevailing market rates. In short, limitations are imposed on the availability of credit, and the increased difficulty of obtaining funds is not fully reflected in interest rates. For a firm with alternative sources of finance at reasonable rates, limitations on the availability of credit from its usual sources may merely imply a moderate increase in the effective rate they must pay on borrowed funds. For firms without such ready access to reasonable alternatives, the effective increase in interest rates is much sharper since they must resort to lenders with significantly higher charges. For some firms, therefore, the potential effects of changes in the availability of credit from their normal sources are much greater than anything they are likely to encounter from general interest rate changes. In fact, however, changes in the availability of credit have had much the same effects as changes in interest rates. During recent periods of credit restraint, some firms have postponed or abandoned particular projects because they were unable to obtain credit or were reluctant to turn to higher-cost alternative sources. In general, however, limits on the availability of credit have not been sufficiently stringent to exercise more than a limited influence over investment in plant and equipment.

Business investment in inventories has sometimes been regarded as particularly likely to respond to credit restraint. However, we found little evidence of such responsiveness, and there appears to be little relation between non-farm inventory target levels and rates of interest. It is widely accepted by firms that desirable inventory levels are determined by technological factors, changes being largely independent of changes in the financial costs of carrying inventory. In some cases, firms reduced inventories because of suggestions made by their bankers or other lenders or because of changes in the availability of credit, but the total of such shifts appears to be small. Such evidence as we have also suggests that farm inventories and grain in commercial channels are largely unaffected by credit restraint.

Government expenditure on goods and services also tends to be relatively insensitive. In the course of our hearings, some of the provinces and municipalities drew attention to reductions in their capital expenditures in response to credit restraint. When all the evidence had been assembled and compared with total expenditures during the relevant periods, however, it became clear that provincial and municipal expenditure had been curtailed very moderately. The benefit to be derived from capital expenditure by governments can rarely be assessed in the same terms as business investment and the resulting rate of return compared with the cost of funds. Instead, governments must be influenced by their judgment of the need for particular expenditures and of the political consequences of failing to meet the continuing demand for expanded services. If these judgments suggest that expenditures be continued, governments are rarely dissuaded by an increase in interest rates of the kind we have experienced. Moreover, expecting rising prices, they may feel that the higher cost of carrying out these projects later will more than offset the extra interest payments involved. Nevertheless, interest payments constitute a tax burden, and in some cases high interest rates acted as a deterrent to capital expenditure. Similarly, limitations on the availability of credit to municipalities have had some effect on expenditure, although in other cases a decision was taken to go to the market earlier than had been planned and capital projects were not postponed.

It ought to be relatively easy to determine the effect of credit restraint on personal consumption expenditure. We are all consumers and, while we may not be fully aware of all the reasons for our decisions, ought to be able to recognize the extent to which we have altered any of our plans in response to increases in interest rates and limitations on the availability of credit. However, despite evidence that consumers are sensitive to interest rates in the sense that they alter the form of their savings, aggregate data and surveys are inconclusive as to the effects on saving in total. Despite the growth of contractual saving, in pension and other forms as well as in repayment of outstanding debt, it is apparent that personal saving does fluctuate from year to year, but there is no available evidence showing that a firm relationship between personal saving and interest rates does, or does not, exist.[11]

It has generally been thought that consumers who are borrowers are ordinarily quite insensitive to increases in interest rates, although they will respond in a fairly marked way to significant changes in the amount of down payment or in monthly payments resulting from a shortening in the terms of the loan. Since there is an important element of service costs in most consumer loans, the effective rates of interest are often very high and an increase of 1% or 2% in the general level of interest rates—even if reflected in a change in the rates charged on consumer loans—will have a relatively small effect on the total cost of borrowing. On the other hand, many consumers encounter difficulty in providing a larger down payment or managing the higher monthly payments which result from a shortening of the period of the loan. Thus, Canadian experience and that of other countries suggests that changes of this kind do have substantial effects on consumer expenditure financed by instalment loans.

In the case of housing, the consumer's commitment is for a larger amount outstanding over a long period and a significant increase in the mortgage rate thus leads to an increase in debt servicing costs which is substantial in relation to the consumer's income. However, the most substantial changes in expenditures on new residential construction have come in periods when there was a lack of availability of N.H.A. mortgage funds. As explained in Chapter 14, when credit conditions are relatively easy, institutional investors have found N.H.A. mortgage lending a profitable outlet for funds. If, however, long-term interest rates rise and no change is made in the N.H.A. rate, the yield differential between N.H.A. mortgages and other investments becomes unattractive and institutional investors tend to withdraw from N.H.A. lending. If the Central Mortgage and

[11] A rise in interest rates has opposing effects on saving—it increases the reward for saving but reduces the amount needed to achieve a given target.

Housing Corporation does not provide direct loans to overcome the resulting shortage of N.H.A. funds, builders and purchasers have the choice of financing through conventional mortgages—with their combination of higher interest rates, higher down payments and shorter term —or postponing construction.[12] This change in the terms of available mortgage funds has significantly affected the level of expenditure on housing.

Some of the domestic effects of credit ease are merely the opposite side of the coin to credit restraint. For example, the greater availability of N.H.A. loans in 1957-58 led to a significant increase in housing expenditure in 1958 because demand had been effectively restrained largely by the lack of availability of mortgage funds on favourable terms. Moreover, during this period the demand for housing remained high, and after being curtailed by credit restraint during a boom it could be encouraged by credit ease during a recession. In the case of other types of domestic expenditure neither of these conditions held. Credit restraint had had limited effects on expenditure and it could therefore be anticipated that credit ease would have limited effects. In addition, there have frequently been sharp changes in the demand for other goods and services arising from actual or anticipated changes in the level of economic activity, with demand and expenditure falling at the same time as credit conditions have eased. Thus a shift from restraint to ease could not have been expected to lead to major and observable changes in domestic expenditure.

Such evidence as we have gathered suggests that the increase in domestic expenditure, other than on housing, which has been brought forth by a decline in interest rates and an increase in the availability of credit has been very small. This is in line with the frequently expressed view that monetary policy can be effective in restraining a boom but is less effective in stimulating a recovery, and reflected in statements such as "You can lead a horse to water, but you can't make him drink" or "You can't push on a string". During periods of economic weakness, attempts to stimulate investment by easing credit conditions are usually thought likely to be frustrated by a lack of incentives to invest. Indeed, if there is much excess capacity and the economic outlook is poor, the expected profitability of much investment may be negative. This is not unlike the state of affairs during the 1930's when general credit ease had less effect than many had anticipated and the notion tended to develop that monetary and debt policies were relatively ineffective in providing a stimulus to demand.

Anyone who is sceptical of the effects of credit restraint must qualify his remarks by setting a limit to the vigour with which restraint is applied. There have been many financial panics in the past when interest rates have risen to abnormal levels and lack of availability of credit has led to widespread bankruptcies. There is clearly no room for doubt that extreme financial conditions do have important effects on economic activity even if business conditions are buoyant and inflationary sentiment strong. Thus, if the normal level of short-term interest rates is 3%-4% and if international or other complications could be ignored, there will be some rate which is effective in restraining demand, even though it might be well over 6%. While theoretically there is no limit to the extent of the increase in interest rates, there is such a limit on the extent to which a decrease can be brought about by conventional monetary and debt policies. The short-term rate on treasury bills can be reduced from its norm to almost zero but cannot be made negative. There is therefore more possibility of effectiveness on the side of restraint if action is restricted to the use of conventional policies.

These differences between the effectiveness of credit restraint and credit ease were only partially significant in recent years. During recessions, there was excess capacity in many industries and the economic outlook was not favourable, but there was not any major collapse of expectations. Sim-

[12] Since an N.H.A. mortgage must be taken out as the house is being built, it is not possible for borrowers to obtain short-term finance from other sources and subsequently take out an N.H.A. mortgage when they are freely available again.

ilarly, although the over-expansion of some types of plant and equipment during the investment boom of 1955-57 removed the incentive for further investment, this was not true of all industries and firms and capital formation continued to go forward in both good years and bad. Over a wide range of investment, therefore, it was possible for credit ease to exert some influence. That such an influence is very difficult to find results in part from the nature of the changes in credit conditions during the 1950's. Throughout the decade, there was an upward trend in interest rates, each period of ease being merely a valley on the side of a hill. In most cases, changes in the direction of ease were less pronounced than changes in the direction of restraint, and thus less likely to lead to a positive response.

There are other reasons why the response to credit ease might be expected to be small as compared with that to credit restraint. We have already noted the insensitivity of firms which rely heavily on internal funds; other firms of course have less need for outside funds during a period of low investment. Moreover, firms which attempt to time their borrowing in relation to conditions in financial markets may borrow heavily during a period of credit ease, but this may have little or no effect on the timing of their capital expenditure. Finally, there can be delays in planning which impede the response to credit ease. Under conditions of credit restraint, some firms with plans all ready to proceed may decide to postpone or abandon one or more projects. While this is not an easy decision, it can readily be implemented if a start has not been made on construction or an order has not been placed for equipment. On the other hand, the framing of plans is necessarily time-consuming and if a decline in interest rates or an increase in the availability of credit leads to a decision to undertake a larger program of investment, there may be considerable delays before expenditures are actually increased. This problem will not be encountered if long-range planning is undertaken and if expenditure which has been curtailed by credit restraint is permitted to go forward in a period of ease. Despite the growth of such planning, however, conditions have frequently been found to have changed enough so that a project is no longer attractive in its original form.

The identification of such response to credit ease as does exist is made more difficult because when credit is readily available and interest rates are lower than they have been in the past, credit conditions may not be accorded a great deal of importance. A decision to proceed with a particular expenditure might not have been taken if conditions had been tighter, but it is particularly difficult to separate this effect from the many other factors influencing the decision. Thus, the very limited reaction to credit ease revealed by questionnaires and interviews probably understates the effect on domestic expenditure. For example, the proportion of respondents to our consumer survey who indicated that they would step up their purchases of houses and cars under significantly easier credit conditions was only a fraction that of those who indicated they would curb their purchases under comparable conditions of restraint. Yet we have no doubt that the greater availability and more favourable terms of consumer credit in the post-war period has had a considerable impact on the buying of consumer goods.

THE INTERNATIONAL EFFECTS OF CHANGES IN CREDIT CONDITIONS

The discussion above has been limited to the direct response of domestic expenditure to variations in credit conditions. This is the relationship which is important for countries operating under a fixed exchange rate system. If capital flows freely in response to interest differentials under such a system, a change in capital movements will have its major effect on the exchange reserves rather than on the exchange rate. However, under a flexible exchange rate system with large-scale capital flows—the system under which Canada operated during the 1950's—changes in credit conditions can also have an important indirect effect on expenditure through the exchange rate.

Under the flexible rate system, a change in credit conditions in Canada which raised interest

rates relative to those in other capital markets tended to reduce domestic expenditure directly and thus reduce imports to some extent.[13] The initial improvement in our international current account—which under a fixed rate system leads to gains in exchange reserves—tended under a flexible system to increase the international value of the Canadian dollar. If there were no capital movements or changes in official reserves, this change in the exchange rate would have had to be such as to lead to other changes in international trade to restore the original current account position—i.e. other imports would have had to increase or exports decline, a process which would further curtail spending in Canada. Since the original domestic effects of credit restraint are not large, the adjustment in the exchange rate under these conditions would not normally need to be very large either. However, during this period capital was flowing freely into Canada and credit restraint which widened the differential between our interest rates and those elsewhere encouraged greater capital inflows and pushed the international value of the Canadian dollar still higher. The resulting additional encouragement to imports and discouragement to exports thus exercised a significant dampening effect on economic activity not found under a fixed exchange rate system.

The importance of this effect on domestic expenditure turns, among other things, on the extent to which capital movements respond to interest rate differentials and to which trade responds to changes in the exchange rate. Our evidence suggests that while some capital flows are immediately responsive to changes in credit conditions, small and temporary fluctuations in the exchange rate are unlikely to have a major effect on trade. As we shall indicate below, there are other sources of balance over the short run, including stabilizing speculative capital movements. However, exchange rate movements which are larger and expected to persist will exercise a major effect over trade. Thus, under a flexible exchange rate system, the international effects of changes in credit conditions which alter the interest differential between Canada and other countries have important repercussions on our foreign trade and therefore on domestic economic activity, provided they extend beyond a short period.

[13] The supply of exports might also be increased in conditions such that high levels of domestic demand had previously diverted production to the home market.

THE LAGS IN THE RESPONSE OF EXPENDITURE TO CREDIT CONDITIONS

In any assessment of the potential usefulness of monetary and debt policies, it is important to know the timing as well as the size of their effects on expenditure and output, particularly when credit conditions are varied frequently. It has long been recognized that the tardy response of the economy to policy changes poses a problem, but for the two decades prior to 1950 this was not a major issue. Many leading countries maintained easy credit conditions throughout the 1930's and 1940's and with the policy instruments set in one direction the timing of their effects did not greatly matter. Thus, the high unemployment existing in the Canadian economy in the late 1930's could hardly be imputed to lags in monetary policy's effectiveness. Indeed, it was not until a flexible monetary policy was restored in the 1950's, and reversals of policy began taking place every two or three years, that timing became a matter of major importance. We are concerned here with the time between a change in credit conditions and the resulting changes in output and employment, because without some knowledge of the delays involved one cannot be sure whether even the promptest action by the authorities will have an effect soon enough to stabilize, rather than de-stabilize, the economy.

There appears to be little delay in the recognition of a significant change in credit conditions by the financial officers of governments and corporations. They may not all dissect the weekly report of the Bank of Canada, but they do deal in financial markets on a regular basis. They are thus quickly made aware of any major change in market rates of interest and the availability of funds. This is not to say that there is much re-

sponse of expenditures to the early stages of a policy of restraint or ease. In some past periods, short and long rates of interest have risen for many months before there has been any significant response from those making capital expenditure decisions. Indeed, our enquiries have pointed up the fact that the first few months of a gradual change in credit conditions have usually been taken up in bringing the financial system to the point where it begins to exert a restraining influence over expenditure. An exception to this general tendency occurred in 1962, when the change in credit conditions was dramatic. The fact that there were other uncertainties present—including a foreign exchange crisis—and that the change came after a long period of bank loan expansion makes this rather a special case. It does nonetheless indicate that a decisive change in interest rates and bank lending policies can have a rapid impact on capital expenditure decisions.

A change in the decision to undertake or not to undertake a capital project will naturally not have an immediate effect on employment and output. Most capital expenditures in the current period are for projects started in previous periods, while most decisions made currently involve expenditures in subsequent periods. The extent of the lag depends upon the nature of the project. This can be illustrated by a series of examples drawn from the period of credit restraint in mid-1962. An oil company which decided to reduce its service station program for 1962 would have carried the program to completion in the summer and fall of that year. The construction of a ship which was postponed in 1962 was scheduled for completion in the spring of 1963 so that any direct employment effects would have been felt during the period mid-1962 to early 1963. Some warehouse construction which was postponed because of the unavailability of bank credit would have been undertaken in the summer and fall. Replacement expenditure of $600,000 which was planned by an engineering contractor would have been made by the fall. A construction materials firm which postponed the purchase of cars and trucks reduced the sales of motor vehicles in 1962. A small building products firm which was negotiating with a lending institution when credit was tightened was unable to obtain funds for expansion and postponed expenditures which would have been mainly made the same year. A small, but rapidly growing, industrial products firm was planning to modernize equipment but was discouraged by "tight money talk" and did not make its purchase in 1962. A medium-sized oil company postponed a pipe line project from the 1962 construction season to the next construction season.

Some of the direct and indirect effects of the postponements or abandonments listed above—which, though numerous, did not involve a high proportion of business capital expenditures—would have spilled over into 1963 and beyond, but it is evident that much of the effect would have been felt fairly quickly. We found other cases where the lags were much longer. A paper manufacturer who did not purchase a paper machine estimated that the employment effects of this would extend over a period of two and a half years. Part of the work on the new buildings required to house the machine would have been carried out in 1962, but the construction of the machine itself would have been spread over a much longer period and might well have taken place in another country. An oil company which responded to the 1962 change in credit conditions reported that it was planning to restrict expenditure in the next year as well. A power company which postponed the start of a project was able to provide fairly precise information indicating that the result would be a fall in expenditure in 1962 and 1963 and a subsequent rise in 1964 and 1965, with the bulk of the restraining effect coming in 1963.

The lags in residential construction are much less complex than those found in government expenditure and corporate investment. It has sometimes taken a considerable interval for the yield differential between N.H.A. mortgage loans and other investments to alter and therefore for institutional lending to be affected significantly, but once this has occurred—or a decision has

been taken to alter CMHC direct lending—housing starts can be affected very quickly. Our econometric work suggests an average lag of about three months, with the lag on occasion being as short as a few weeks. The submission of the Central Mortgage and Housing Corporation suggests that peaks in residential construction activity are likely to lag peaks in starts by as much as four months, reflecting the length of the construction period and the timing of work done within that period.

We have already indicated that the major effects of changes in credit conditions which have come through changes in the exchange rate are felt with a considerable lag. Some international capital flows respond quickly, but there may be compensating movements which reduce the immediate effect on the exchange rate; moreover, long-term capital flows respond more slowly. However, even if the rate responds in a matter of months, it takes time for adjustments to be made by producers, and these will be limited if the change is in any event expected to be temporary.

In summary, there is considerable variation in the lags between the time when credit conditions are brought to the point where they exert an influence over different categories of expenditure and the time when those effects are felt in the economy. For some categories of expenditure such as residential construction, the lags are variable but fairly short and fairly easy to predict. In other sectors of the economy, the lags depend upon the nature of the expenditure, but a major proportion of the direct effects on employment and output may come within a period ranging from a few weeks to 6-9 months, although other effects —both direct and indirect—will extend into later periods. Our evidence suggests, moreover, that these lags can be shortened considerably by fairly dramatic changes in credit conditions, especially if the climate of business opinion and expectations is significantly affected by the policy measures themselves or by other events in the economy. Finally, the evidence seems to indicate that for all but the very shortest of cyclical fluctuations, the actions of the authorities can play a useful stabilizing role, although the variable nature of some of the lags means that there is a risk that the effects of previous policies may exert some restraining influence after conditions have changed and ease is called for. These effects are most likely to be seriously harmful when inappropriately restrictive policies are persisted in.

A CASE STUDY OF CREDIT RESTRAINT IN 1958-60

The complex nature of the problem of estimating the extent and timing of the short-run response of the economy to changes in credit conditions can be illustrated by considering the period of credit restraint 1958-60. The seasonally adjusted annual rates of gross national expenditure in the fourth quarter of 1959 and the first and second quarters of 1960 (the peak of the expansion) were $35.4 billion, $36.0 billion and $35.6 billion respectively. As things turned out, the level of economic activity during these three quarters was well below the capacity of the economy, but the appropriateness of policy is not the issue here. We can observe what in fact happened, but we must infer what would have happened under alternative credit conditions if we are to assess the effects of the changes in credit conditions which took place during this period.

It would be misleading to suggest that the techniques of measurement used permit precise definition of the alternative credit conditions assumed. We have, however, used as a benchmark the credit conditions which might have resulted from a decision to operate as far in the direction of ease as was consistent with the avoidance of a large-scale depreciation of the exchange rate. We assume this would have entailed credit conditions characterized by a very moderate rise in interest rates and little restraint on bank lending. Using this set of credit conditions as a reference point, estimates have been made of the effect on expenditure of the variation of credit conditions which actually occurred, i.e. an increase in treasury bill rates from around 1% in mid-1958

to over 6% in August, 1959, a rise in yields on long-term government securities from around 4% to 5.6% and significant restraint on bank lending.

We have not been able to make an estimate of the direct effect on consumption of the change in credit conditions which occurred in 1958-60. Consumption is a very large component of expenditure and even a moderate response to increased interest rates or limitations on the availability of credit would be quantitatively significant. Consumer credit outstanding increased from around $3.2 billion at the end of 1958 to $3.6 billion at the end of 1959, although personal loans by the chartered banks against marketable securities fell from $287 million in 1958 to $282 million in 1959—presumably because of the curb on lending for speculative purposes. Other bank personal loans stopped rising for some months during 1959. Some individuals were refused loans during the period and some of them in fact curtailed their expenditure on durable goods, but our impression—supported by the results of our consumer survey—is that this was not a common occurrence.[14]

In an attempt to obtain added information on consumer responsiveness to changes in credit conditions, some hypothetical questions were asked in our consumer survey. The results suggested a much higher responsiveness than previous evidence and the data on aggregate consumption expenditure would support, but there is reason to believe that the information obtained is misleading. For example, of the 388 respondents who had purchased automobiles on credit in the period 1957-62 and who were asked what they would have done if higher finance charges had required them to pay 5% more per month—i.e. $3 to $4 more per month on a new automobile contract—no less than 48% replied that they would have deferred or downgraded purchases. Moreover, 41% replied in a similar vein when asked for their probable response to a shorter-term loan with monthly payments 10% higher.[15] For housing, the responses of 543 households were just as extreme, 46% indicating that they would have postponed or made cheaper purchases if monthly mortgage payments had been 10% higher owing to higher interest rates and 37% making the same comment about a similar increase stemming from a shorter-term loan. Interestingly, however, only 2% to 8% of respondents replied that they would make a more expensive purchase in the reverse circumstances.[16]

We are sceptical about these results for a number of reasons. First, hypothetical questions are always hazardous and the responses are much less reliable than those based on decisions which have actually been taken; this is especially the case when it is not possible to follow up subsequently and verify the answers against actual behaviour. Secondly, the questions were difficult and it is evident from the comments of respondents and of the interviewers that they were not always fully understood. Thirdly, there were numerous replies which indicated that respondents objected strongly to the level of interest charges that they had in fact paid and as a matter of principle felt bound to indicate that they would postpone purchases if they were any higher.

Our scepticism is supported by the evidence which the survey obtained on actual spending decisions. All respondents were asked if they had deferred purchases of houses or cars in the five years 1957-1962 after seriously considering them (to the point of checking prices, credit terms and other details). For houses and cars, 10% and 8% of respondents respectively reported deferrals, but the dominant reason was that they were too expensive. Only one-tenth of these deferrals were attributed to financing difficulties of any kind; of these a part stemmed from apparent unwillingness to pay any rate of interest within the range

[14] 4% of households reported being refused a bank loan in the period 1957-62, but only one-quarter of the respondents were given tight credit conditions as the reason and not all of these occurred in 1959-60.

[15] A 5% increase in monthly payments involves an increase in effective interest rates of from 18% to 24% over a two-year contract: if monthly payments are 10% higher, all other factors unchanged, the term of the loan is shortened by 2½ months.

[16] The questions and the replies are tabulated in the appendix volume.

charged in recent years.[17] Respondents who had not deferred purchases commonly commented that changes in interest rates or financing terms were not a factor in their decisions or—when they were—that other considerations of a special kind over-rode them.

The modest response of actual spending decisions on housing and cars to changes in credit conditions in the period is broadly consistent with aggregate data and other evidence. At the same time, the hypothetical results are not completely irrelevant for assessing consumer behaviour in the case of more drastic changes in credit conditions. For example, the changes suggested in the questions on housing were equivalent to a rise of 1¼% in the interest rate on a 20-year 6½% mortgage or to a shortening in term of about 3½ years. The proportion of respondents—about 25%[18]—who stated that they would postpone purchase of a house in such conditions, can be compared to the 20%-25% reduction in planned housing outlays that occurred in 1956-57 when N.H.A. funds were less freely available. (Allowance must be made for the fact that some of these reductions in consumer spending on houses would have fallen on existing houses and thus not have directly affected gross national expenditure and that the results of the survey apply only to those who used credit to finance their purchases.)

The hypothetical response for automobiles seems to have less relevance for the future, although it may be indicative of the effect of direct controls. While the stringent consumer controls in the Korean War period did not appear to have effects as dramatic as those indicated by the survey, it may be the case that the disappearance of demand backlogs, the spreading use of consumer credit, the importance of debt repayment in many budgets, and the lack of inflationary fears have increased consumer sensitivity to such controls. In short, while we have every reason to believe that the answers to the hypothetical questions in the consumer survey overstate the responsiveness of consumers to even dramatic changes in credit conditions, we believe that they are not entirely irrelevant. Further research into consumer behaviour might yield fruitful results on the effectiveness of monetary and debt policies.

Returning to the actual response of consumer spending to the changes in credit conditions which took place in 1959-60, it appears unlikely that the direct effect on consumption of the increase in interest rates or reductions in the availability of credit was of major importance during the period, particularly since only a small proportion of total consumption (excluding housing) is financed on credit. As noted earlier, we have no direct information on the response of personal saving to changes in credit conditions. Net personal saving declined in 1959, but this is a residual item in the national accounts and it is dangerous to infer anything from it. However, it is important to note that even if the short-run *direct* effect on consumption of a change in credit conditions is small, any decline in income arising from a fall in expenditure elsewhere in the economy will lead *indirectly* to some decline in consumption.

Government expenditures on goods and services (excluding expenditures of publicly owned enterprises whose principal sources of revenues are derived from the provision of goods and services to the public) amounted to $6.5 billion in 1959. Of this, $2.85 billion was spent directly by the federal government on goods and services, while expenditures by provinces and municipalities—and the school boards and hospital districts within their jurisdiction—totalled $3.65 billion. We have already referred to the testimony received from the provinces and the municipalities and the general conclusion we reached after examining all the evidence. In the case of the provinces, this finding was further tested by correspondence relating particularly to capital expenditures during the period 1958-60. It was found that to the extent that any reliable judgment could be made there had been little response to credit restraint in provincial capital

[17] However, a significant number of house buyers indicated that they found the term of mortgage loans too long, or the loans too large, for their needs.

[18] 9% of survey respondents indicated that they would postpone housing purchases if the down payment were 10% higher.

expenditure. It was almost as difficult to find much evidence of significant responsiveness on the part of municipalities, school districts and hospital boards. Some municipalities which found bank financing difficult in the latter half of 1959 went to the market rather earlier than planned but did not postpone capital projects. Putting together the evidence derived from interviews with representatives of the provinces and municipalities with a direct analysis of provincial and municipal expenditure during the period, we would conclude that the amount of expenditure postponed was in the range of $10-25 million. A portion of this expenditure would have been carried out during the peak quarters, but it is not possible to date the impact on expenditure with any accuracy.

Despite the sensitivity of new residential construction to changing credit conditions, outlays on new housing were not greatly affected in this particular period. Loans by approved lenders fell off sharply during the latter half of 1959, and for the year as a whole were down to $280 million from $510 million in 1958. However, Central Mortgage and Housing Corporation acted as the residual lender for home owner applicants through most of the year.[19] Over $340 million was committed in the first ten months of 1959, and by November the Corporation had exhausted its available funds. However, the decline in lending came too late to reduce the level of economic activity until the second quarter of 1960. In short, the substantial effect of credit conditions on private N.H.A. lending, and thus on housing construction, was almost entirely offset by direct public lending. The net effect on residential construction was therefore minor in the first two peak quarters, almost certainly not exceeding $50 million at annual rates, compared to recorded housing expenditures of about $1,675 million annually in the same period.

Expenditures on new non-residential construction and new machinery and equipment ran at levels of from $5 billion to $5.4 billion in the three peak quarters. In 1959 as a whole, the capital expenditure of private and public non-financial corporations totalled $4 billion, while those of the 80 largest private and public corporations totalled $2 billion. It has been estimated from the results of the corporate survey that the capital expenditures of the latter firms in the last quarter of 1959 and the first two quarters of 1960 would have been $20-25 million higher if credit conditions had been significantly easier.[20] For the firms of smaller size, the estimate is based on less adequate information but it appears that the effects of changes in credit conditions were of the order of $30-40 million in the three peak quarters. The latter estimate includes an allowance for changes in the expenditure of proprietorships and partnerships operating in the fields of manufacturing, commercial services and trade.

The effects estimated above, while surprisingly small, were distributed through all the size classes of firms. When large firms postponed expenditure, they generally did so because they were unwilling to borrow at current rates. A few large firms postponed expenditures because of doubts about the advisability of expansion during a period of credit restriction, while an occasional large firm encountered difficulty in obtaining the funds it needed. Almost without exception, however, their adjustments to planned capital expenditures were marginal in nature. Among the smaller firms, there was generally little reaction to the change in interest rates; it was rather the case that they found themselves unable to obtain increased credit from their usual sources. In some instances, these limitations were sufficient to cause expenditures to be postponed but in others the firms found alternative sources, frequently at higher cost. The proportion of smaller firms which did change their capital expenditure was no greater than that of larger firms, but they did so to a greater degree; the differential effects were not large.

The small number of firms which indicated a response to credit conditions makes it difficult to say much that is meaningful about regional or

[19] Loans to builders were not available for part of the year.

[20] This, like our other estimates, is the estimated direct effect of easier credit conditions. There is no reliable way of measuring the indirect effects on individual expenditure components.

industrial distribution. It can be said, however, that the effects have not been concentrated in particular regions or particular industries, a finding which confirms that of other studies.[21]

There are other components of gross business fixed capital formation which were not covered by the corporate survey. These included agriculture and fishing with capital expenditures in 1959 of over $500 million; finance, insurance and real estate with capital expenditures of over $250 million; and hospitals, private schools, churches and universities with capital expenditures of $200 million. Staff studies and interviews have thrown some light on the degree of responsiveness to credit conditions of these sectors of expenditure.

Capital expenditures in agriculture and fishing appear to be, if anything, less affected by changes in credit conditions than are non-farm corporate capital expenditures. Capital expenditures in finance, insurance and real estate include the building and equipping of offices for financial institutions and the construction of non-residential buildings by firms whose object is to lease or sell the premises rather than use them for their own operations. Expenditures of the latter type are the major part of these expenditures and are affected considerably both by the availability of mortgage funds and of interim construction credit from the chartered banks. Expenditures in this category might have altered by up to 5% in late 1959 and early 1960, although most of the expenditure consequences of decisions made at that time would appear in a later period. The evidence on the third category, including hospitals, private schools, churches and universities, is very limited. While some financing difficulties were encountered as a consequence of credit restraint, there is little indication that any significant amount of construction was postponed.

Non-farm inventories increased by $300 million, $700 million and $400 million in the three peak quarters. Interest rates are only one element in the total carrying cost of inventories and even those firms which have recently introduced new techniques for controlling inventories do not generally take into account changes in market rates of interest in establishing inventory levels. There were, however, some firms which responded to credit restraint in 1959 by reducing their inventories below the level which would have existed under easier credit conditions. In some cases this was the result of limited availability of funds, and in one important case it was a response to the anticipated effect of credit restraint on sales. It is estimated that expenditure in the three peak quarters may have fallen by something of the order of $10-25 million.

As indicated in our earlier discussion, the effect of credit conditions on the exports and imports of goods and services under the flexible exchange rate system is a very complex one. During this period, the interest rate differential between Canada and the United States widened significantly and exercised an influence over capital flows which added to the exchange rate effects resulting from the reduction in import expenditures. The average value of the Canadian dollar rose by approximately 2½ cents from U.S. $1.025 to U.S. $1.05 from February to November 1959. Under the alternative credit conditions we have assumed, we visualize that the Canadian dollar by the fall of 1959 might have been worth only U.S. $1.00. If this is a plausible guess, and it is little more than a guess, all the evidence which we have available—derived from economic arithmetic, econometric analysis and the surveys —seems to suggest that this rate change would have had limited effects on the flow of trade; these effects might have been of the order of $150-$250 million in the three quarters. At the same time, the volume of imports would have tended to increase because of the direct effects of higher levels of domestic expenditure resulting from easier credit conditions. This estimate of the overall effect of credit restraint on our trade balance is necessarily a very broad one, and since the possibilities of error are compounded by the several steps in the process of estimation the results should be regarded as of limited reliability.

The total of all these effects of changed credit conditions on expenditures will be greater than the

[21] See, for example, Report of Professor A. K. Cairncross to the Atlantic Provinces, Atlantic Provinces Research Board, 1961.

sum of the component parts. Any decline in public and private investment, in consumption or production for export, or in domestic production because of replacement by imports, tends to reduce incomes and hence to have further effects on consumption and investment. Some people who would have been at work in the fall of 1959 and the early months of 1960 did not have jobs as a result of the direct and indirect effects of credit restraint. Unemployment insurance and dissaving could provide some support for their expenditure but some decline in consumption would result. Similarly, capital expenditures that might have been made in the period if demand had been stronger never took place. To put all these effects together in a satisfactory manner would require more information than we have available, or indeed is ever likely to be available.

Within the inherent limitations of any attempt to measure the impact of credit conditions on expenditure, however, we can attempt to summarize our findings of the combined effect of changed credit conditions in 1958-60. Our survey of firms identified effects on capital investment of from $50 to $65 million in the three peak quarters, a figure which is probably an understatement because of the impossibility of identifying the subconscious effects which tight credit conditions may have had on spending decisions; the original replies indicated a higher responsiveness, but follow-up interviews enabled us to determine that some of the reasons for postponements were not primarily connected to changes in credit conditions. Institutional, financial and real estate enterprises combined, principally the latter, appear to have curtailed investment by from $10 million to $20 million in the three peak quarters, while the impact on the spending of agricultural and fishing enterprises, which we surveyed less completely than the other categories mentioned, clearly did not exceed $10 million and may well have been virtually nil. We estimate that housing expenditures fell by $30 million to $50 million in the period, with much of the effect falling in the latter part of it; the effects would, of course, have been bigger but for the direct lending of CMHC. If we add to these figures our survey and other results for the change in non-farm inventories resulting from changed credit conditions, we obtain measurable effects in the range of $110 million to $195 million. Converting these three-quarter data into annual rates, we obtain a range of $150 million to $250 million, figures which may be compared with an average annual rate of G.N.P. of $35¾ billion in the period.

To these figures must be added some allowance for the effects of changed credit conditions on consumption, on which our data are admittedly sketchy. However, the behaviour of the aggregate figures suggests that consumer expenditures on new automobiles and other durables, which averaged under $2.7 billion at annual rates in the period, could scarcely have been affected by more than 2% to 3%.

Finally, there would have been secondary repercussions on incomes from this deferred spending. While we have no evidence as to their magnitude, the behaviour of the economy and other indications do not suggest that they are likely to be so large as to alter the totals dramatically. Within the period mentioned, for example, it would not be possible to conceive of these effects trebling—or even doubling—the direct impact of credit conditions on expenditures. If we take a figure of under 50% as being more representative of the order of magnitude likely to be involved, the total direct and indirect effects would range from $275 million to $450 million. To measure the results on Canadian economic activity, a deduction must be made for the proportion of this expenditure which would have fallen on imports. Thus corrected, the indicated direct and indirect effects of credit restraint on domestic expenditures would be of the order of $200 million to something over $300 million at annual rates, i.e. from just over ½ of 1% to just under 1% of G.N.P. Under a floating exchange rate system, $150 to $250 million would be added to these totals.

We wish to emphasize again the difficulty of measuring the economy's responsiveness to

changed credit conditions—especially in the consumer sector—and draw attention to the hazards involved in estimating its indirect effects. Nevertheless, we believe that our estimates give a reliable indication of the orders of magnitude and confirm that the effects are significant enough to be worth striving to achieve at the right time. This was especially the case under a flexible exchange system, since the effectiveness of credit policy was much greater under such a system. Although attempts were made to assess the significance of the subtle and elusive influence of changes in credit conditions on the general business climate, this proved more difficult to evaluate. For example, certain new projects—especially of a promotional kind—may never have been seriously considered because of the tightness of credit conditions. To the extent that we have failed to take this effect fully into account, our results err on the low side and underestimate the short-run contribution which monetary and debt policies can make to stabilizing the economy.

THE IMPLICATIONS OF THE 1958-60 EXPERIENCE AND OTHER EVIDENCE

The experience of 1958-60 can be compared with that of other recent periods of credit tightness. In 1956-57—the first occasion in the postwar period when major use was made of interest rates to impose restraint—there was an understandable reluctance to push the use of conventional monetary and debt policies too far. Partly because of this, partly because business conditions and expectations were unusually buoyant, and partly perhaps because the period is well in the past, the effects we were able to discover in the corporate sector were smaller than in 1958-60 and in mid-1962. On the other hand, the effects of credit conditions on residential construction were much higher, perhaps of the order of $200-$300 million, because the Central Mortgage and Housing Corporation did not offset them with direct lending.[22] The international effects were also significant, although it is not easy to estimate what would have happened to the exchange rate in the absence of credit restraint; in fact the Canadian dollar appreciated by over four cents from March 1956 to March 1957. Given that the effect of credit restraint on residential construction in 1956-57 was about equal to all domestic effects on the rest of the economy found for 1958-60 and that the international effects were probably no less, the total impact of credit restraint in 1956-57 exceeded that of 1958-60.

The sharp increase in interest rates brought about by the authorities in mid-1962 was designed to deal with a loss of exchange reserves rather than to contain an excessive boom. The action taken was, however, very vigorous, and the effects on corporate investment which we have been able to identify are of the same order of magnitude as in 1958-60. The effects on residential construction were small since the Central Mortgage and Housing Corporation continued acting as a residual lender for home owner applicants and conventional lending rates hardly changed. The measures of 1962 were effective in influencing the flow of capital, but we were by then operating under a fixed exchange rate and the large scale capital inflow was felt primarily on official reserves; the effect on the exchange rate, and thus on the flow of goods and services, was minor. The absence of any significant international effects on expenditure, and the modest impact on residential construction, reduced the total impact of the mid-1962 credit restraint substantially below that of the two preceding periods.

The results of our inquiry may also be compared with those of our counterparts in the United States and the United Kingdom. The Commission on Money and Credit (C.M.C.) did not attempt any aggregate estimates, although they did discuss the quantitative consequences of changes in credit conditions in a few selected areas. They pointed out that "estimates of the percentage of state and local expenditures shifted from the late phases of a boom to the following

[22] The Corporation did not become a major direct lender until September, 1957.

recession range from 2 to 5 per cent".[23] Our estimates are at the lower end of that range. They also found effects on residential construction in both 1955-57 and 1959, which they suggested ran to declines of roughly 15% to 20%; this is comparable to the case in Canada when residential construction bore the full brunt of the decline in N.H.A. lending in 1956-57. For the rest, their analysis was cast in very general terms. It was pointed out that high-leverage speculative investments such as real estate would be sensitive to monetary policy—of which we, too, found evidence—and that investment in long-lived assets and investment for mechanization and cost reduction would also be affected. They also argued that in the absence of anticipated price increases, investment in inventories "seems likely to be somewhat sensitive to interest rates and credit terms".[24] Their evidence indicated that changes in credit terms had "some, but only a slight, direct effect on consumer expenditures for other than residential construction".[24] The general impression we derive from reading their report as a whole is that they expected larger domestic effects from changes in credit conditions, except for housing, than our evidence suggests are likely to occur in Canada.

The Committee on the Working of the Monetary System in the United Kingdom (the Radcliffe Committee) did not attempt any total quantitative assessment of the effect of monetary policy, although their report brought together a considerable amount of evidence on the subject. They thought it unlikely that the "quick" effects of interest rates on personal savings would be sufficient to "justify consideration when a rapid adjustment of the level of demand is needed". They also concluded that there "was no sign that consumer spending was forced down" by restraint on bank lending and that "stocks of commodities are extremely insensitive to interest rates". In general, their evidence on the lack of responsiveness of corporate investment was broadly similar to ours. In assessing the effectiveness of particular monetary measures, they took the view that a minimum effect of £100 million in a year provided a rough test of whether a measure altered expenditure in a significant way and remarked:

> ". . . . we find it difficult, on such evidence as we have received, to believe that any of the changes in interest rates have by themselves had an impact of this order of magnitude. The squeeze on bank advances in 1955-56 perhaps would, if the impact could be measured, qualify by this criterion. Almost certainly the change in hire purchase control, when at all substantial, did have effects of this order."[25]

Given the size of the Canadian gross national product in recent years, an effect of $150-$200 million in a year is the rough equivalent of an effect of £100 million in the British economy in the nineteen-fifties. Thus, while the C.M.C. concluded that monetary policy was "a valuable and effective instrument of economic policy", the Radcliffe Committee concluded that monetary measures "are incapable by themselves of having an effect sufficiently prompt and far-reaching for their purposes, unless applied with a vigour that itself creates a major emergency".

Both groups, however, had doubts about the effectiveness of credit ease in stimulating expenditure. The C.M.C. argued that "while the processes and channels through which monetary measures operate are the same for a policy of ease as for a policy of restraint, an expansionary policy may be less effective than a restrictive policy."[26] The Radcliffe Committee had little to say about the effects of credit ease during periods of mild recession, but in their discussion of a catastrophic slump it was suggested that "it follows from what has already been said of the effects of monetary measures that they cannot be expected to act quickly enough or alone to bring about even a slow complete recovery."[27]

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[23] *Money and Credit*—The Report of the Commission on Money and Credit, 1961, Prentice-Hall Inc., page 51.

[24] *Ibid*, page 52.

[25] *Report of the Committee on the Working of the Monetary System*, H.M.S.O. Cmnd. 827, paragraph 471.

[26] *Op. cit.*, page 54.

[27] *Op. cit.*, paragraph 521.

The estimates summarized above and compared with the findings of similar bodies in other countries apply primarily to the effects of short-term variations in credit conditions over the range experienced in Canada. As suggested earlier, these are the most relevant magnitudes for most purposes, given the close relationship between Canada's capital market and that of the United States. A vastly different set of credit conditions could only exist if somewhat similar changes were occurring in the United States, although this does not necessarily mean that Canada will have no freedom of action to vary credit conditions in the future. Be that as it may, a persistently different state of credit conditions from mid-1958 onwards would probably have had substantial effects on employment and output. A lower international value of the Canadian dollar might have been expected to emerge from easier credit conditions. If maintained over an extended period, it would have had a significant effect on the flow of international trade in goods and services and thus significant direct and indirect effects on economic activity. Moreover, the existence of lower short and long-term interest rates over an extended period would have created a more certain climate which would have encouraged new projects to go forward and would have given individuals, corporations and governments time to adjust their other plans to a different set of credit conditions. There would of course have been domestic and international reasons for not allowing the exchange rate to depreciate drastically, and thus there would have been limits to the extent to which credit conditions in Canada could have been allowed to diverge from those existing abroad. Even within these limitations, however, the domestic effects would have been significant.

Our analysis so far has looked to the past, but our results are primarily of interest because of the light they may throw on the future effectiveness of changes in monetary and debt policies. The effects of changes in credit conditions on housing expenditure are likely to be reduced by the relative weakening in the demand for housing and by the improvements in the conventional mortgage market: the impact of reduced availability of mortgage funds on residential construction will be still further softened if our proposals on N.H.A. and conventional lending are adopted. On the other hand, the effects could still be larger than those of 1958-60 and 1962 if the government does not offset them by increased direct lending. Borrowing costs will remain an important consideration for provincial and municipal governments, but there is little reason to suppose that these governments will respond to changed credit conditions in a significantly different way in the future as long as their financial position remains strong.

There is similarly little indication that those making business capital and inventory decisions will become more responsive to variations in credit conditions over the range we have experienced in recent years, although more modest profit margins and the growing importance of capital in their total costs may have slight effects in this direction. Their insensitivity in the past has not arisen from an unawareness of changes in credit conditions, firms often adjusting their financial arrangements to them. However, the effects on their decisions to purchase goods and services can probably be expected to remain limited in view of the substantial use made of internal funds, the need for firms to make investments to protect their competitive position and the relatively unimportant role of interest costs in affecting their return from new projects. Wider changes in credit conditions might be expected to have significantly greater effects, but in the absence of such changes it seems unlikely that there will be any significantly greater response from consumers, governments or corporations than we have already experienced. Finally, the effects of changing credit conditions on expenditure through exchange rate variations are not likely to be present.

CONCLUSION

No one seriously engaged in trying to determine the effectiveness of monetary and debt poli-

cies can expect to obtain a simple "yes" or "no" answer. We have found that monetary and debt policies are indeed effective in influencing expenditure, but we have also found that if variations in credit conditions do not exceed those experienced in recent years—when changes have been by no means insignificant—these effects are limited. In the absence of the special factors causing changing credit conditions to have a particular impact on housing outlays and on international trade, the potential effect of monetary and debt policies on expenditure will be reduced. This is as true for the longer term as it is for the short: with the exchange rate fixed, a long-term change in credit conditions can have neither as helpful—nor as harmful—an effect on spending as was the case in the past.

It does not follow, however, that monetary and debt policies are worthless or dispensable. The effects which we have found, while perhaps smaller than many people would expect, are still significant when compared with the fluctuations of expenditure which public policy attempts to mitigate. It should also be recognized that the impact of changed credit conditions on spending is not independent of the prevailing environment or the wisdom of the policies being pursued: a movement of short-term rates from 2% to 6%, for example, will have a greater effect on spending in conditions of relatively modest expansion than in boom periods, especially if persisted in. In such circumstances, many of the decisions to expand plant which might otherwise have been taken may simply not be considered at all because of the unfavourable financial environment. Similarly, the maintenance of conditions of extreme credit ease in boom periods is very likely to lead to excesses which will have serious effects on real economic activity, even though such a policy would have very much more limited effects in stimulating economic activity in contractionary periods.

Whatever doubts there may be about the size of the effects of significant changes in credit conditions on domestic spending in differing circumstances, there is no doubt that the prompt and immediate reactions in financial markets have a strong influence over flows of international financial capital. Under a flexible exchange rate system, this influence will lead to exchange rate effects which have an additional impact on domestic expenditure, but even though this effect is missing under a fixed-rate system, monetary and debt policies still play an important part in dealing with problems arising out of international capital movements which affect our exchange reserves. The prompt effect of such policies on international capital flows—while sometimes limiting the use of credit policies for purely domestic aims—at least gives the authorities an instrument which allows them reasonable freedom to use other policy weapons for domestic purposes. In short, monetary and debt policies can play a useful role in maintaining a balanced international financial position and averting crises which might otherwise arise because of undesirable developments in the flow of capital between Canada and other countries.

Finally, monetary and debt policies have an important part to play in stabilizing the economy because money will not manage itself: not the least contribution which sensible monetary and debt policies make to the attainment of economic goals is in preventing extreme variations in credit conditions with all their accompanying disturbances and crises. The absence of such monetary disturbances, which used to be a prominent feature of financial events and an important cause of "booms and busts" in the economy, is now so much a part of the background of expectations and the business climate that it tends to be taken for granted. But in any assessment of the importance of monetary and debt policies, it is well to recognize that the avoidance of major catastrophes—and their attendant excesses of optimism and pessimism which so dramatically affected spending decisions—and the creation of a stable underlying environment are extremely helpful in promoting national economic objectives.

Thus we are convinced that "money does matter", although the direct domestic effects of changes in credit conditions—especially minor changes—are not as great as some recent discus-

sion would suggest. Moreover, failure to ensure that monetary and debt policies are at least broadly appropriate to the circumstances can have harmful effects on the economy's performance. While we wish we had been able to find greater stabilizing effects from the variation of credit conditions, we believe that our findings do suggest that monetary and debt policies have a constructive role to play in stabilizing the economy. We hope that these findings will encourage others to search for further evidence on the size and timing of expenditure changes induced by changing credit conditions, for we are the first to recognize that our own results should not be accepted uncritically and that future conditions will in any event lead to differing degrees of responsiveness.

Assuming that we can count on the authorities to aid in avoiding any major financial crises and to prevent the economy from being affected unnecessarily by other disturbances, we are still left with the problem of how monetary and debt policy can exert enough influence over spending to mitigate significantly the fluctuations in expenditure which are bound to occur from time to time. While there is scope for widening the range of variation of general credit conditions beyond the boundaries of the recent past without unduly disrupting either financial markets or domestic business activity, international considerations are likely to rule out this alternative if similar changes are not taking place in other countries, particularly the United States. The consequences on our official reserves would then be serious and the policy would sooner or later have to be modified. There may be occasions when selective credit measures and the creation or retention of imperfections in the financial markets will help to minimize these international complications or otherwise enhance the effectiveness of policy—as we shall indicate in the next chapter—but in normal circumstances we are opposed to such measures because of their adverse effects on efficiency and on the development of competitive and adaptable financial markets. Yet even if future circumstances allow more variation in domestic credit conditions, monetary and debt policies will have weaker effects on domestic expenditure under a fixed exchange rate.

Our findings thus lead us to the conclusion that monetary and debt policies must be teamed up with others if the economy is to achieve its full potential. Seriously-wrong monetary and debt policies can have disastrous effects, but the positive contribution which appropriate credit conditions can make to economic goals is such that monetary and debt policies cannot be expected to play an unsupported role in stabilizing the economy: they must be strongly supported by fiscal and other policies.

CHAPTER 22

THE TECHNIQUES OF MONETARY POLICY AND DEBT MANAGEMENT

We have concluded that the influence of short-run changes in credit conditions on real spending is likely to be relatively small and in some cases considerably delayed. We now turn to examine the techniques employed by the monetary and debt authorities to alter credit conditions; the limitations on the range of variation of credit conditions in the long run as well as the short (bearing in mind the view that a more persistent change in such conditions may have a significant influence on expenditure); and finally the measures which may be taken to overcome these limitations.

We discuss the techniques of monetary policy and debt management in a single chapter because these instruments work together to bring about changes in economic activity through their combined influence on the terms and conditions prevailing in financial markets. While in Canada there is a formal division of authority within government as to the responsibility for monetary and debt management operations, with the Bank of Canada having immediate responsibility for conducting monetary operations and the Minister of Finance exercising responsibility for the government in matters of debt management and foreign exchange policy, it nevertheless remains true that attempts to draw clear distinctions between monetary and debt policies are of limited usefulness.[1] The authorities cannot view policies affecting the supply of money and the structure of the federal debt as being unrelated: they each have influences on credit conditions and spending and must be harmoniously combined.

Indeed, all instruments of financial policy and their combined effect on financial conditions and spending must be viewed as a coherent whole. For example, if it has been decided that economic conditions call for expansionary measures which result in a government deficit, this will need to be financed. The way in which it is financed will have an influence on credit conditions and the need for these operations must be taken into account when decisions are being made on the steps required to influence credit conditions in the direction and to the extent that the circumstances appear to justify. The other steps required may be limited to operations on the cash reserves of the banking system, but they may also include operations in the market by the Bank of Canada or the government's own accounts which alter the maturity structure of the debt in the hands of the public without any net influence over cash reserves. These techniques are all serving a common end. The more they are viewed as a co-ordinated whole the more likely it is that the use of different techniques can be varied to suit the particular circumstances of the time; the greater also will be the possibility that the authorities will be able to influence credit conditions with a minimum of difficulty and disruption.

The essential unity of monetary and debt management operations was strongly emphasized in the Report of the Committee on the Working of the Monetary System submitted in the United Kingdom in 1959. The Radcliffe Committee

[1] The position of the Bank of Canada within government is fully discussed in Chapter 26.

defined the public debt as the net liability of the government sector as a whole; this includes the note and deposit liabilities of the central bank as well as interest-bearing government debt but excludes securities and cash held in government accounts or the central bank. This approach emphasizes that all government actions which influence the size and structure of public holdings of cash and interest-bearing government debt are similar in their effects. Although agreeing with the point made by the Radcliffe Committee, we have found it convenient in the somewhat different Canadian institutional circumstances to follow the usual practice of defining the federal debt as including all outstanding securities, wherever held, in order to simplify the exposition. We therefore will deal separately with the techniques of debt management within the context of all financial policy. However, changes in the state of the debt held by the public may result from sales and purchases of securities by the Bank of Canada as well as debt issue, retirement or market transactions carried out for the government: such central bank operations are treated as an integral part of debt management and discussed in the following section.

A great variety of operating procedures may be used by both the monetary and the debt authorities to influence financial markets and spending decisions. The use of one technique rather than another is of secondary importance compared to the adoption of a correct balance of policy, but the particular choice may still have important implications for the economy or financial markets. Some of the measures discussed in this chapter, such as alterations in the supply of cash reserves or in the structure of the public debt, operate in a general way by affecting the cost and availability of credit. Although some sectors of the economy will be affected more severely than others as a result of market imperfections, differing reliance on borrowed funds or their own sensitivity to financial considerations, these measures operate indirectly through their effects on financial markets generally. They thus differ in principle from measures which are designed to strike directly at the amounts and terms of particular types of credit by using or creating market imperfections.

Extensive use of the direct measures may create distortions in the financial system, lower its efficiency, and indeed lead to widespread practices designed to evade their impact. The immediate usefulness of such techniques must be carefully weighed against the inequities and lasting harm they may cause. The general instruments do not present these problems, but they also must be used skillfully if government action is to be effective. Ill-chosen and badly-managed operations will disrupt financial markets unnecessarily and the resulting uncertainty may limit the authorities' freedom of action and the effectiveness of their attempts to influence economic activity. Moreover, if conflicting actions are taken the impact of all government measures on credit conditions and expenditure may be reduced.

THE MANAGEMENT OF THE FEDERAL DEBT

(i) *Principles of debt management*

Because of its size, the important role it plays in portfolios and the central position of the markets where it is traded, the federal government's debt is a major factor affecting financial conditions. Despite the much more rapid growth of other forms of debt since the war, the federal debt was still the largest category of primary debt outstanding in 1962, representing almost 27% of the total. Trends in the total, maturity structure, and composition of the federal debt are shown in Table 22-1. Changes in the amount, type and distribution of the federal debt interact with other forces at work in financial markets to affect flows of funds and the state of credit conditions. The principles on which the debt is managed over the cycles of economic activity therefore have important implications for monetary and financial policies generally.

Those who take a doctrinaire view on this question divide into two main camps—those favouring counter-cyclical management of the debt and those favouring a policy of minimizing at all times the interest and other costs of government borrowing. Given the type of marketable debt

TABLE 22-1

DIRECT AND GUARANTEED FEDERAL DEBT OUTSTANDING

(as at December 31)

—	Treasury bills, notes and deposit certificates[a]	Other Market Securities				Total Market Debt	Non Market Debt[d]	Total	Average Maturity of market debt			
		2 years & under[b]	2 to 5 years	5 to 10 years	Over 10 years[c]				Total		Public[e]	
									years	mos.	years	mos.
	(millions of dollars)											
1940	785	484	642	468	2,834	5,213	26	5,239	10	5	—	—
1945	1,796	1,049	1,676	2,200	10,071	16,792	692	17,484	10	6	—	—
1950	1,500	1,300	1,498	4,983	5,393	14,674	1,218	15,892	8	1	—	—
1952	1,400	2,109	2,548	3,894	3,985	13,936	1,250	15,186	6	9	—	—
1954	1,530	1,749	2,302	4,292	3,503	13,376	2,090	15,466	7	2	9	6
1956	1,575	2,197	2,150	4,800	1,971	12,693	2,541	15,234	6	7	7	6
1958	1,495	2,334	2,006	1,947	5,739	13,521	2,895	16,416	10	4	13	4
1960	1,985	2,251	2,806	1,160	5,950	14,153	3,594	17,747	9	5	11	6
1962	2,165	2,545	2,443	2,472	5,103	14,729	4,719	19,448	8	5	10	9
	(Percent)											
1940	15.0	9.2	12.3	8.9	54.1	99.5	0.5	100.0	—	—	—	—
1945	10.3	6.0	9.6	12.6	57.6	96.0	4.0	100.0	—	—	—	—
1950	9.4	8.2	9.4	31.4	33.9	92.3	7.7	100.0	—	—	—	—
1952	9.2	13.9	16.8	25.6	26.2	91.8	8.2	100.0	—	—	—	—
1954	9.9	11.3	14.9	27.8	22.7	86.5	13.5	100.0	—	—	—	—
1956	10.3	14.4	14.1	31.5	12.9	83.3	16.7	100.0	—	—	—	—
1958	9.1	14.2	12.2	11.9	35.0	82.4	17.6	100.0	—	—	—	—
1960	11.2	12.7	15.8	6.5	33.5	79.7	20.3	100.0	—	—	—	—
1962	11.1	13.1	12.6	12.7	26.2	75.7	24.3	100.0	—	—	—	—

[a] The Government retired the final $200 million of deposit certificates in 1952 and the final $500 million of treasury notes in 1956.

[b] Includes matured issues still outstanding.

[c] Includes undated issues ('perpetuals').

[d] Includes Refundable Tax and War Savings Certificates in earlier years: since 1954 Canada Savings Bonds only, except in 1962 when $100 million of non-marketable debt held by the Unemployment Insurance Fund is included.

[e] The "Public" is defined as all holders other than government accounts, the Bank of Canada and the chartered banks.

issued by the government, its average term to maturity declines continuously and steps must be taken from time to time to issue new longer-term securities. The proponents of a counter-cyclical debt policy argue that the public's debt holdings should be lengthened in periods of credit restraint by the issue of new long-term securities and sales of existing long-term debt from official accounts—including the central bank's—in exchange for shorter maturities. These operations will tend to raise the whole level of interest rates and put particular upward pressure on long-term rates, to which expenditures are thought to be especially sensitive. Debt operations would thus reinforce the effects of monetary policy working through cash management and the banking institutions. During periods of credit ease, on the other hand, proponents of this view argue that the government's requirements should be more than met by new issues of short-term debt while longer issues are bought in by the authorities. These operations would shorten the public's debt holdings and thus assist in easing credit conditions.

Opponents of counter-cyclical debt management have argued that the cyclical timing of long-term issues should be precisely the opposite of this. They argue that the issuance of long-term securities during periods of credit restraint is unnecessary. Cash reserve management is adequate to raise or lower interest rates over as wide a range

75319—30½

as overriding limitations on the freedom of policy will permit and major changes in the average maturity of the debt in the hands of the public are not required. Moreover, by forcing the government to borrow long-term funds at high interest rates, counter-cyclical debt management will significantly raise the cost of servicing the debt. Thus it is held that the debt manager should seek to minimize the cost of the debt by issuing long-term securities during the recession periods when long-term interest rates are near their cyclical lows, and refrain from offering long-term securities when rates are near their cyclical peaks. The principles of portfolio management which this approach would suggest for the Bank of Canada and the government accounts is to seek to maximize profits by selling long bonds when prices are high and buying them in again when prices are low.[2]

These are not the only rules according to which the debt might be managed. Some would argue that since government debt operations are necessarily very large relative to the size of our financial markets they can cause serious disturbances whose harmful consequences more than offset any advantage. Since they also argue that debt management cannot itself have important effects on the level and structure of rates, they recommend that the authorities should follow a regular pattern of debt issue and management, placing and refunding issues at regular intervals in order to maintain a uniform maturity structure of the debt. This policy would serve to average the cost of the debt over cycles in interest rates, but its proponents have also argued that since investors could take account of future government issues—whether to raise new funds or refund maturing debt—certainty and stability in markets might well serve to lower the government's average borrowing costs.[3]

The policies followed in Canada since the war do not fall clearly into any one of these categories. However, they come closer to the interest minimization pattern than the counter-cyclical techniques for most of the period. During the early post-war years, the practice of maintaining fixed bond prices and repaying debt from cash surpluses implied an unwillingness to use debt operations (or, for that matter, cash management operations) as a stabilizing technique. When this policy was abandoned, only limited efforts were made to offset the shortening of the debt until the recession year 1954.[4] The debt in the hands of the public was allowed to shorten again in 1955 and 1956, with purchases of long-term securities by the Bank of Canada and government accounts doing much to moderate the rise in their yields at a time when a restrictive monetary policy was being followed. One long issue, the $3\frac{3}{4}$'s of 1996-98, was offered in September 1956 but this was the only attempt during the period of restraint 1955-57 to lengthen the publicly-held debt. The issue was priced too high for successful distribution and the authorities were obliged to take up a substantial part of it. During this period, an apparent unwillingness to allow long rates to rise above 4% nullified the attempt to lengthen the debt, and the net effect was that the restrictive monetary policy being followed was less effective than it might have been.

The debt continued to shorten during most of 1957. However, in early 1958, when an expansionary monetary policy was being followed to combat a recession, this process was reversed. The limited efforts to lengthen the debt in early 1958 were dwarfed by the huge Conversion Loan in the period July-September which at one step increased the average term to maturity of the publicly held debt from 96 months on June 30, 1958 to 178 months on September 30, 1958. In the years since the Conversion Loan, which in-

[2] The view that government should pay no interest on its debt, financing its needs solely by the issue of currency, is the reductio ad absurdum of a cost minimization approach. Such a policy in conjunction with deficits in the government's accounts would lead inevitably to extreme credit ease throughout the system, an exchange crisis and finally uncontrollable inflation. Many of those who propose this view ignore the physical limitations on economic output, assuming that what can be paid for can be produced at current market prices.

[3] A forceful presentation of this approach may be found in *Techniques of Treasury Debt Management* by Tilford C. Gaines, Free Press of Glencoe, 1962.

[4] See Chart 9 in Chapter 20 showing changes in the average maturity of the debt.

clude two periods of credit restraint and two periods of relative credit ease, the publicly held debt has shortened continuously, the only exception being the fourth quarter of 1962. Thus there is little in the record to suggest that during much of the post-war period monetary and debt policies were harnessed for the achievement of common objectives—or indeed that any consistent debt policy was being followed. In the past few years, however, considerable experimentation with new techniques and more careful coordination of monetary and debt policies have reduced the disruptions resulting from debt management and increased its usefulness as an instrument of policy.

The choice among the various principles on which the debt may be managed depends on the balance of advantage and disadvantage of each when viewed in the full context of government economic policy. Taking first the cost minimization policy, the advantage sought is a reduction in the charge on the government to meet interest on the debt, matched either by reduced taxation or increased government expenditure in more useful directions. Despite a recent revival in a subtle form of the "burden of the debt" controversy,[5] it is generally accepted that domestic interest payments are best thought of as part of a transfer process which has effects on the distribution of incomes and wealth and involves some administrative costs but does not impose other real burdens on the community as a whole. Since virtually all of the federal government's debt is held within Canada, the transfer argument applies in our case. Thus the real effects of any reduction in the present level of net interest payments on the federal debt—which amount to some $750 million—would depend on the differing spending and saving habits of taxpayers and investors in government securities (if taxes are reduced by the full amount) or upon the differing spending patterns of investors and governments (if other government expenditures are raised). Whatever the outcome, it is safe to assume that the effect on the economy would be much less than the change in the government's interest payments.

It must also be recognized that there is no precise indicator of the best time to issue longer-term debt. The authorities can never be sure when rates are low that they will not go even lower. Nor can they be certain that it will in fact be more advantageous to issue a one-year bond which must be refunded each year for five years at unknown rates than to issue a five-year maturity at prevailing rates. Moreover, if repeated attempts are made to sell long bonds at the low point in the interest cycle, investors will become disillusioned and demand higher returns on such bonds, thereby offsetting much of the interest-cost benefits of attempting to pursue the cost minimization objective to an extreme point.

However, the principal objection to following this policy at all times is not that its real effects are small or that it is difficult to know what measures will in fact minimize costs, but that such a rigid rule would complicate the authorities' task of establishing suitable credit conditions by precluding the use of the debt as an aid to other arms of stabilization policy.[6]

We discussed the strengths and weaknesses of counter-cyclical management of the debt with many of the witnesses who appeared before us. Some argued that alterations of the debt structure can have powerful effects on the level and structure of interest rates and should be vigorously used to achieve them.[7] A more common view was that debt management can have only limited independent effects on interest rates. With some variations of emphasis, this judgment was expressed by Sir Dennis Robertson from his study of developments in the United Kingdom,[8] by Mr. Bernstein on the basis of U. S. experience[9] and by other

[5] See, for example, "Is the National Debt a Burden?", by E. J. Mishan, *The Banker*, September, 1963.

[6] Sales of long-term securities at the low point in the interest rate cycle (the peak in bond prices) may aid the authorities during a succeeding period of higher rates by "locking in" investors—i.e. making them unwilling to sell their bonds at less than they paid for them—and thus perhaps reducing their spending from what it might otherwise have been. The same effect can be achieved—perhaps more appropriately—by selling long debt in the early part of a restrictive period

[7] See, for instance, Submission of Professor Clarence Barber and his evidence, Transcript, pages 880 to 896.

[8] Transcript, page 5132.

[9] Transcript, page 4487.

witnesses. The consensus appeared to be that although management of the debt can nudge the rate structure usefully, powerful effects are not to be expected.

Differences in the views expressed reflect both experience in the countries concerned and the magnitude of debt operations envisaged. Thus, comments on the United States must reflect the rather limited changes in the debt structure associated with the recent Treasury and Federal Reserve policy known as "operation nudge". Beginning in 1961 the U.S. authorities took steps to alter the maturity structure of the debt in public hands in order to maintain short-term interest rates at a higher than normal level relative to long-term rates for international reasons.[10] This was done by raising new funds with increases in the treasury bill issue and by the practice adopted by the Federal Reserve System of adding to bank reserves by purchasing longer-term securities. So far as the United Kingdom is concerned, Lord Cobbold in his evidence before us stressed the pressing need during his tenure as Governor of the Bank of England to lengthen the debt whenever possible and laid correspondingly less emphasis on counter-cyclical policies.[11]

Judgments about Canadian experience are to a degree dominated by the dramatic lengthening of the debt in 1958 through the Conversion Loan. In the first half of 1958, considerable uncertainty had developed in securities markets following extensive speculation in an apparently successful long-term CNR issue early in the year. This culminated in the failure of two long issues delivered on May 1.[12] It was decided that in order to clear away the substantial blocks of Victory Bonds which were approaching maturity ($947 million were to mature in January 1959, and a further $1,165 million in June 1960, with the remaining three Victory issues totalling $4,304 million maturing in 1962, 1963 and 1966) and to restore confidence in Government bonds, all the Victory issues should be converted into longer-term securities. During a two-month campaign from mid-July to mid-September reminiscent of the war bond drives, $5,806 million of the four Conversion issues, representing 45% of the outstanding market debt, were issued in exchange for the Victory Bonds. There can be little doubt that the substitution of long for short bonds to an extent that raised the average maturity of public holdings from 8 years to almost 15 years contributed significantly to the upward adjustment in rates at that time and to the maintenance of relatively high rates thereafter.

However, it is now generally accepted that this massive operation created considerable difficulty and complicated the authorities' task subsequently. The major difficulty was that the liquidity of the economy was substantially reduced at a time when, despite some evidence of an economic upturn, the underlying economic situation was weak. Moreover, a debt management exercise of this magnitude was almost certain to cause some disruption of markets. The declared objective was conversion of all Victory Bonds, including the issue with final maturity in 1966 which was not callable before 1961, and to achieve this end the terms were made extremely attractive and the operation was presented as a patriotic endeavour which deserved unanimous support. Moreover, the prices of the Victory Bond issues were raised and fixed at very attractive levels[13] so that throughout the operation and for some weeks thereafter the Bank of Canada had to support bond prices in the face of a rapid upward adjustment of interest rates in the United States. Thus partly for technical reasons that might have been avoided, debt management inter-

[10] The absolute level of long-term rates was nevertheless higher than that which would have obtained had international considerations allowed the U.S. authorities to pursue a policy of ease throughout the yield structure.

[11] Transcript, pages 4045-49.

[12] It might be noted that some of the speculative pressures which contributed to the disruption of markets in early 1958 could have been avoided if government financial policy had been clearer and if the Bank of Canada had been following the technique of more recent years of making additional amounts of new issues available to markets when strong demand develops. This technique tends to curb any sharp rise in prices and to dampen excesses of speculative enthusiasm by dealers and their customers. However, it should be pointed out that speculative pressures were widespread in North American bond markets at that time, as the collapse of the U.S. bond market in mid-1958 showed very clearly.

[13] Because there was a set structure of margins between the Victory Bonds and the new conversion issues, prices of the latter were also effectively fixed.

fered with monetary policy at a crucial time. When market support was withdrawn and market prices fell away, investors felt themselves deceived.

Even without these complications, a funding operation of this size was bound to create conditions in which it would be difficult to reduce interest rates if that should prove desirable. Having been severely shaken, the market would not soon have been prepared to carry government securities at much lower rates, even if a major attempt had been made to reverse the exercise by substituting short for long bonds in private portfolios. In effect the authorities committed themselves to relatively high rates for a considerable time, a step which was to prove unfortunate in the light of subsequent events. A smaller operation, more flexibly managed and offered as an option rather than a duty would not have brought all these difficulties in its train.

It should be noted that the Conversion Loan in 1958 revealed fundamental conflicts in policy. The budget brought down on June 17 emphasized the need for expansionary measures and forecast a record peacetime cash deficit of $1.4 billion. Sales of long-term securities could not be regarded as an expansionary move, although it was claimed that the Conversion would make it easier for other borrowers to obtain long-term finance. In the event, credit conditions tightened markedly despite the considerable monetary expansion which took place, and corporations, provinces and municipalities turned to the U.S. capital market for their funds. This led to upward pressure on the value of the Canadian dollar that was to say the least no positive stimulus to domestic expansion. If rapid adjustments of rates are desirable for domestic or international reasons they can be achieved through monetary policy acting on the system's cash reserves. Massive support from debt management is not essential. In view of this fact and of the disturbances which can result from overly ambitious debt operations, such extreme ventures in debt management should be avoided.

This, however, leaves open the question of whether more limited counter-cyclical debt policies should be followed. The Conversion Loan may not have been undertaken for counter-cyclical purposes, but it had major effects on interest rates. It is reasonable to conclude that more limited operations would have smaller but nonetheless significant effects and there is some supporting evidence in Canadian experience. For instance, the official purchases of long-term debt in 1956 undoubtedly served to lessen the increase in long-term rates, misguided though the policy may have been. A happier instance came with the steps taken following the June 1961 budget when establishment of the Purchase Fund to support long-term issues, switching operations by the Bank of Canada and the announced temporary suspension of new long issues all served to take pressure off prices in that part of the market. The cancellation of all market securities held by the Unemployment Insurance Fund, a high proportion of them long-term issues, also assisted in reassuring the market by removing the threat of sizable sales. These debt operations —or announcements of operations which would not be undertaken—provided useful support in promoting easier conditions in financial markets.

Again in 1962, imaginative public debt transactions assisted in bringing about the rapid market changes necessitated by the foreign exchange crisis. The instrument chiefly relied on was monetary policy: because of rapid loan increases and pressure on their cash positions, the banks made heavy sales of securities in June, July and August which resulted in the sharp upward adjustment of rates needed to check the losses of foreign exchange. However, in the course of reducing cash reserves the Bank of Canada operated in all maturity classes, selling first treasury bills in order to drive short rates up particularly quickly but soon shifting the weight to the long end of the market. In August, a $120 million loan maturing in 1980 was issued, increasing the pressure on long rates, and in August and September the Bank sold $140 million of long-term issues. The cash effect of Bank transactions was reduced by temporary transfers of government cash balances and

transactions with the government's Securities Investment Account.[14] The entire operation, which also involved sizable switches from the Bank's portfolio, demonstrated the manner in which co-ordinated monetary and debt operations can bring about rapid, smooth adjustments of credit conditions. It can be argued nevertheless that a greater reliance on debt management might have been useful. More substantial official sales of medium and long-term debt (matched by offsetting purchases of short bonds in the case of Bank of Canada sales) might have driven rates up with less need for the banks to sell bonds. Thus, the banks' ability to follow the relatively free lending policies which were appropriate domestically throughout the external crisis would have been less impaired by pressure on their liquidity. However, this is a gloss on a successful operation carried out in circumstances that left no room for delay.

These few incidents have exemplified both the harm and the help that debt management can bring to government financial policy. If they demonstrate anything, it is that flexibility is of the essence. It is our view that an attempt to follow any rigid program of debt management would be undesirable. Strict adherence to cost minimization objectives or to the "neutral" objective of maintaining a uniform debt structure through a regular pattern of issue and retirement would sacrifice the help in adjusting credit conditions which careful management of the debt can provide for the sake of achieving subsidiary goals. Moreover, the neutral procedure could not easily be adjusted to the government's changing needs for finance and might lead to positively undesirable interest rate consequences as investor preferences shift for cyclical or other reasons. On the other hand, a counter-cyclical policy pressed in season and out might also involve the authorities in operations which would disrupt markets. For instance, it is difficult to sell long-term issues when bond prices are falling and failure to price an issue sufficiently attractively may lead to highly disorderly market conditions. In any case, investors must be paid returns attractive enough to persuade them to hold government bonds in the long run—and over a period of years these costs might not be widely different under either policy. Similarly, even if a policy of cost-minimization is not being followed, the government must offer issues designed to minimize interest costs within the context of the policy being followed—an under-priced issue which leads to subsequent speculation can be as disrupting to markets and the government credit in the long run as one which fails to attract buyers because it is over-priced.

The monetary and debt authorities are responsible for financing the government. Given the other policies being pursued, they are at the same time responsible for attempting to achieve a state of credit conditions which will be conducive to the achievement of the broad objectives of economic policy. If they succeed in influencing credit conditions in the direction and to the extent required, they will have achieved their major objectives. At some times, as in the summer of 1962, it might be desirable to make considerable use of debt operations to raise interest rates in order to lessen the need for bank sales of securities to drive rates up: such sales may lead to an undesirable restriction of bank lending. In another conjuncture of domestic and international circumstances a different mix of policy measures might be used to achieve a somewhat different pattern of credit conditions.

An additional device which has been proposed as part of counter-cyclical debt policy and to aid in varying the pattern of credit conditions is variation in the size of government cash balances held in the chartered banks. It has been suggested to us that during periods of economic buoyancy when the government is running a cash surplus, the funds should not be used to repay debt but rather be held in the form of cash balances in the chartered banks. These cash balances could

[14] See *Bank of Canada Report for 1962*, pp. 52-53. It is not possible to trace the official transactions in published figures for the details of the portfolios of the Bank and government accounts are not revealed: changes in the maturity classes published reflect the passage of time as well as actual transactions. We think detailed publication with a reasonable delay, as in the United States, would contribute much to informed discussion without endangering the authorities' position in any way.

then be called upon during an ensuing recession to finance cash deficits. The objection to the cyclical use of cash balances on a large scale is essentially political. In periods of excess demand, the Minister of Finance might find it extremely difficult to persuade his cabinet colleagues and Parliament that the funds sitting in his accounts should not be used for increased expenditures. However, if there were good reason for supposing that the authorities were unable to vary credit conditions over a sufficiently wide range without the support of this technique, the merits of the proposal would justify the Minister in accepting that risk.[15] On occasion in the past, the gingerly way in which the authorities have exercised their influence over credit conditions has suggested that a supplement of this kind would have been valuable. It is not clear that this is the case today. If a combination of cash surpluses, debt repayment and credit restraint is required, this combination can be achieved through the use of existing techniques without reliance on major changes in government cash balances.[16] While there is no reason to rule out use of this technique, we do not believe it need be a necessary or frequent instrument of policy.

While following a flexible approach to their job, the authorities cannot afford to neglect the continual shortening of the debt as time passes. To do so would be to invite situations in which the immediate needs of debt management seriously limit their freedom of action. There are no precise guide lines to the extent to which the debt can be allowed to shorten before remedial action is taken, but an excessive reliance on short financing will lead finally to problems of continuous refinancing. This will inevitably give rise to almost continuous disruptions in financial markets associated with the sale and delivery of new issues and may seriously inhibit efforts to influence credit conditions. The problem would become even more severe if government should show itself unwilling to pay the price needed to place the issues satisfactorily—that is, if it disagreed with the monetary policy being pursued. If, therefore, opportunities present themselves for debt lengthening which do not interfere with the achievement of the desired state of credit conditions, there is good reason for taking advantage of these possibilities in order to avoid future conflicts of objectives. If the authorities find themselves unable to sell long-term debt over an extended period, this is an indication that the average level of long-term rates is too low.

The practice developed in recent years of gradually retiring parts of approaching issues in exchange for longer-term securities—either at the time of new issues or through gradual "advance refunding" operations by the Bank of Canada or government accounts—has enabled the authorities to look after this problem in an orderly way. This technique, a variant of the "tap" system of continuous issue used in the United Kingdom, permits the authorities to feed long-term issues out without running the risk of unsettling markets with sizable blocks of new long debt. However, there are times, as in 1962, when sale of a new long issue can influence markets usefully and occasions also arise when announcement of a larger issue will serve to attract more buyers.

The merits of different debt issue techniques were discussed in Chapter 16 where we concluded that the methods which have evolved appear to be working well. In this matter, as with the underlying principles of debt management, we believe that the authorities should not be bound by any rigid rules or conventions. They have evolved new techniques, and no doubt as markets develop further and circumstances change will continue to adapt their methods in order to achieve smooth

[15] In the exchange crisis of 1962, for example, the Minister announced that the Canadian dollar proceeds of sales of official reserves would be earmarked and not used for domestic expenditures. In late 1963 and early 1964, the government again accumulated substantial cash balances, perhaps in anticipation of future accumulation of exchange reserves.

[16] If the accumulation of government balances were used to achieve a given state of credit conditions, the initial effect would be to leave bonds rather than bank deposits in the hands of the public. Interest rates would thus be higher than if securities were retired. Less pressure would thus have to be applied directly to the banks, which would therefore be somewhat freer to lend than if the desired level of interest rates were achieved by restricting the cash reserves of the system and obliging the banks and other institutions to sell securities.

and efficient delivery of new issues. In doing so, they should avoid the temptation to experiment needlessly: there is considerable advantage in maintaining continuity in the government's method of approaching the market. If the merchandise is properly priced and designed for the intended buyers, it will sell: if not, the most imaginative technical innovations will not bring in the customers.

This is not to deny that issues may be designed specifically to attract certain types of buyer, as with discount bonds, or to meet particular market situations, as in 1959 and 1960 when five short-term issues convertible into long-term securities were sold in order to tempt long-term funds out of a reluctant market.[17] Features designed to suit market preferences—of which no-call provisions are another example—result in increasing the availability of funds though their ultimate effects on the gross interest costs of the government's debt are more difficult to assess.[18] Sales of issues abroad can also be useful, particularly as a means of obtaining foreign exchange when the rate or reserves are under pressure.

There are, however, limits to our eclecticism. Although the thought has perhaps not been seriously entertained in this country, we think it worthwhile recording our opposition to the sale of securities whose value is linked in some way to changes in the prices of goods and services—so-called 'index' bonds. Such bonds are in reality an admission of the government's failure to achieve one of its main economic goals, and their sale can only complicate the task of achieving it. In inflationary circumstances they are likely to provoke other major adjustments in the system and impair the position of other borrowers who are unable to offer similar terms to obtain needed funds. In addition, this may reduce the public's willingness to accept restrictive measures and merely shift more of the burden of inflation onto other groups in the economy. A lesser disadvantage is that such bonds would compete unnecessarily with equities and reduce the flow of needed risk capital.

As we noted in Chapter 4, the federal government has relied heavily on the sale of Canada Savings Bonds to meet its need for funds. They now represent 37% of the federal debt held outside official accounts and the chartered banks and 50% of the holdings of individuals and non-financial companies. Although in some years they have been made available for much of the year, it has been the practice to concentrate the sales effort during a relatively short period in the fall, and a high proportion of sales occur during this annual campaign. The bonds, which may be redeemed at face value plus accrued interest at any time, have carried attractive interest rates[19] and have competed very successfully with institutional liabilities and other instruments for a place in personal portfolios. As shown in Table 2 of Chapter 7, the $4,620 million of C.S.B.'s outstanding at the end of 1962 accounted for more than one quarter of the main types of fixed-value liquid claims held by individuals, and the share continues to rise.

Although these bonds compete with the federal government's other debt as well as with other savings instruments, it is undoubtedly true that they enable the government to draw funds from a market which could not be tapped on the same scale with conventional market securities. Information prepared for us by the Department of Finance indicates that the average cost of funds, including the administrative and other costs of managing the annual campaign as well as interest payments, has been somewhat higher than for

[17] Any future convertible issues might, however, have some reasonable call feature at the government's option. Outstanding issues are not normally converted before the last available date even when it would be advantageous to the holder to do so: the premium on the long-term issue into which it is convertible will be reflected in its price in any event. If subsequently the conversion becomes unattractive, however, all the bonds will be presented for redemption at the end of their life as short-term maturities.

[18] At the end of 1962, $1,631 million of Canadian National Railway debt guaranteed by the federal government was outstanding. These securities have normally sold and traded at slightly higher yields than comparable direct government issues. The government should weigh the advantages of separate financing for this Crown Corporation.

[19] Since 1956, the coupon yield of each issue has risen over the life of the bonds, encouraging purchasers to hold them until final maturity. C.S.B.'s may be cashed on demand, but the redemption experience between the annual campaigns has been moderate although large amounts may be exchanged for new bonds if the new rate is substantially higher.

other government borrowings. However, costs have not been excessive, and it is in any case impossible to estimate how much higher the yields on other debt would have been if the authorities had attempted to raise larger amounts in the securities markets without making other adjustments in credit policy. It is argued, moreover, that it is desirable for the government to encourage individual thrift by making C.S.B.'s available through payroll deduction or by instalment purchase.

It is our view nevertheless that the government has placed exaggerated emphasis on Canada Savings Bonds. So long as sales are vigorously pressed and attractive yields are offered, substantial amounts will be raised. Once this cycle is established, it is deceptively easy to argue that the government would have great difficulty in meeting its requirements in any other way. It must be remembered, however, that reduced competition from C.S.B.'s would increase the flows of funds into other investments, including not only other federal securities but also the deposits and other liabilities of private financial institutions. The institutions would no doubt invest a part of their increased funds in government debt: more importantly, perhaps, they would be in a position to increase the flow of private funds into mortgage and other private debt instruments. As we noted in Chapter 14, an increased supply of private mortgage funds would enable the government to withdraw gradually from the direct CMHC lending to home-owners which has in recent years been a sizable charge on its resources. These two important offsets to reduced sales of C.S.B.'s—increased purchases of other federal debt and a substantial net reduction in the government's need for funds to finance N.H.A. mortgages—must be taken into account in considering the possible advantages of some withdrawal from the savings bond market.

A move in this direction would also check the tendency for an increasing share of private holdings of government debt to be in fixed-value form and hence immune to the market consequences of changes in security prices and yields. (We would not press this argument far because it is unlikely that changes in the value of their securities contribute much to the impact of financial policy on individuals' spending decisions. Moreover, in the absence of C.S.B.'s, a part of the public would undoubtedly choose to hold equally-liquid deposits in financial institutions.) Finally, there are now a great many savings alternatives open to individuals, and it is increasingly difficult to argue that the somewhat higher costs to the government of C.S.B. borrowing are justified by the social desirability of encouraging thrift in this particular form. We recommend, therefore, that the government consider the possibility of pressing the sales of C.S.B.'s less vigorously. It might be desirable to reduce the maximum permitted purchase below the present $10,000 in order to lessen the element of competition with other government debt.[20] In addition, the rates might be made somewhat less attractive.

(ii) *Organization for Debt Management*

Given the close connection between monetary and debt policy, it is vital that a close working relationship be maintained between the Bank of Canada and the Department of Finance. Information and opinion must flow freely between them for in the absence of frank dealings between the two, neither can do its job well.

Since we take the view that debt management should be an integral part of a co-ordinated program of government policy, we see no advantage in setting up a separate debt management commission within the government organization. In fact it might be a dangerous move, raising the possibility of quite unnecessary conflicts in the government sector's operations in financial markets. Nor do we think it would be desirable to establish a formal committee of investment dealers or others in financial markets to advise the government on the timing and pricing of its new issues.[21] Officials in the Bank of Canada and the Department of Finance must

[20] It will be recalled from Chapter 2 that our consumer survey showed that 56% of C.S.B.'s were concentrated in relatively few households with holdings of $10,000 or more.

[21] Arrangements of this sort exist in the United States: see the Transcript, page 3811 ff, for Mr. Thomas' description of the manner in which these committees operate.

of course keep in close touch with the markets in the course of their daily work. There is nothing to prevent dealers and others from giving opinions and suggestions, whether or not their views are specifically solicited, and formal committees would not in our view significantly improve the information relevant to new issue decisions.

TECHNIQUES OF MONETARY POLICY

Debt management has a place—sometimes an important place—as a supplementary instrument to vary credit conditions. However, the credit instrument on which reliance must mainly rest is monetary policy—the operations of the central bank affecting the amount of its liabilities outstanding, in particular the cash reserves of the banking system.

The techniques used by the Bank of Canada to control the amount of ultimate cash in the system are described in some detail in the Bank's submission to us. Chartered bank reserves consist of Bank of Canada deposits and part of the outstanding note issue. Changes in these reserves result from changes in any other Bank of Canada asset or liability, and can only come about as a result of such changes. Thus if the Bank of Canada alters its total assets, reserves will be affected if there is no offsetting change in some other liability. Taking account of fluctuations in items over which it does not have daily control, such as the note circulation[22] and the ebb and flow of payments through the government's account, the Bank acts on the items which it does control from day to day in order to set the level of bank reserves. By varying its buying and selling prices for government securities, the central bank can increase or reduce its portfolio with consequent effects on cash reserves. These open market operations, and changes in treasury bill holdings at the weekly auction, are the principal techniques of cash management.[23]

BANK OF CANADA BALANCE SHEET
Dec. 31, 1962—millions of dollars

ASSETS		LIABILITIES	
Treasury bills	455	Held by chartered banks:	
		Notes	417
Other Govt. securities	2,427	Deposits	746
Bankers' acceptances	3	Held by others:	
		Notes	1,817
Investment in I.D.B.	158	Govt. of Canada deposits	43
		Other Canadian deposits	38
Foreign currency items	73	Foreign currency items	61
		All other	
All other assets*	114	liabilities*	110
	3,231		3,231

*The principal variable components of these categories are items in the process of settlement—including the float in the government's account—and the Bank of Canada's profit liability to the Minister of Finance.

Cash may also be affected by moving government balances between the government's accounts at the central bank and at the chartered banks—a reduction in the Bank of Canada account increases the banks' cash reserves and vice versa—and such transfers are used each day as the final balancing item to set the desired level of cash for the following day. The central bank makes recommendations about the amounts to be drawn down or re-deposited as part of its cash management function, but transfers are carried out under the Minister of Finance's responsibility and with his concurrence. In practice, the government account is normally used only to smooth out day

[22] The amount of notes in active circulation is determined by the preferences of the public. Under the present cash reserve formula the amount of till money included in legal reserves each month is fixed on the basis of average recent holdings. For this reason, changes in public holdings of notes do not alter legal reserves during a month except to the extent that the banks draw down their deposits to meet the drain of notes or redeposit excess notes with the Bank of Canada for credit to their deposit accounts. The Bank of Canada does not normally allow changes in the note circulation to affect credit conditions, and accordingly takes the necessary offsetting actions.

[23] It has been suggested that the Bank should be 'neutral' at the bill auctions, simply replacing its maturing bills with new ones at the average price and altering its bill holdings exclusively by market transactions before or after the auction. In view of the convenience for cash management of changes at the auction and the market disturbance which can sometimes be avoided in this way, we see no advantage in adopting such a rule.

to day cash fluctuations and most transfers are made to prevent the deposit at the Bank of Canada from altering substantially; thus they serve to offset the disturbing effect which swings in the government's receipts and payments would otherwise have on bank reserves. Operations carried out for the government, whether for domestic securities accounts or for the Exchange Fund Account, do not affect cash reserves so long as the government's deposit account at the central bank is held steady by appropriate transfers of funds to or from its accounts with the chartered banks. Similarly, the Bank of Canada normally maintains a steady net position in foreign currency assets and liabilities and thus its transactions in foreign items seldom affect reserves.

The Bank of Canada acts as agent for the Minister of Finance in all transactions for the government's securities accounts or the Exchange Fund. It also has the power to act as fiscal agent for any provincial government and is permitted to invest in provincial government securities, but these powers have not been exercised. In practice the Bank would find it extremely difficult to act for provincial governments and deal in their securities because of the virtually insoluble problems of equity among different governments that would inevitably arise. (In view of the relatively small annual increase in the Bank's security portfolio, it could make only a limited contribution to provincial financing in any case.) We do not see the same political objection to including provincial securities among those eligible for discount at the Bank of Canada but there would be little advantage in doing so: as a practical matter this would reduce the borrowing costs of provincial governments little if at all.

There are two ways in which the system can obtain cash temporarily from the Bank of Canada. Each chartered bank has a line of credit against which it may borrow for a minimum of one week if it finds itself short of the cash necessary to meet its requirement. The first loan to a bank is made at Bank Rate but at the discretion of the Bank of Canada a higher rate may be charged on an extension or a second loan in the same month. Banks borrow relatively infrequently since neither they nor the central bank regard this as an acceptable means of obtaining cash except in emergencies. Banks more frequently draw extra cash into the system by calling their loans to money market dealers and obliging them to turn to the central bank. As noted in Chapter 16, the recognized money market dealers are entitled to obtain funds (which enter bank cash reserves) by selling securities to the Bank of Canada under an agreement to re-purchase them within 30 days.[24] Transactions are carried out at prices which result in the dealer paying about ¼ of 1% more than the rate on treasury bills[25] for the accommodation, and since this is a relatively costly source of funds they have a strong inducement to find financing elsewhere or to reduce their inventories. Thus the system is not encouraged to borrow continuously from the Bank of Canada. Dealer lines of credit are reviewed from time to time to ensure that they are adequate, but it appears that bank lines are deliberately kept low to discourage direct bank borrowing.[26]

It is important that the central bank be able to bring about rapid and smooth changes in the financial system, and it is frequently argued that delays in response to central bank action result partly from weaknesses in the apparatus of control. Two of these supposed weaknesses are the fact that cash reserve ratios have applied only to the chartered banks and that the requirement relates to their liabilities in a previous period. The first point has been fully discussed in earlier chapters: we agree with the Bank of Canada that the absence of specified reserve requirements applying to other banking institutions has had little effect on the pattern of their response to central bank action. The recommendation made in Chapter 19 for the application of common reserve requirements was based primarily on other considerations.

[24] At the end of 1963, 15 dealers were entitled to use this facility.

[25] The present dual Bank Rate system is discussed below.

[26] See Bank of Canada Submission III, paragraph 54; see also Transcript, pp. 7615-23, in which the Bank of Canada made it clear that any bank's access to central bank credit in unusual circumstances would not be dependent on the size of these lines.

The Bank Act now fixes the base for calculation of reserve requirements each month as the average of each bank's deposit liabilities on the four Wednesdays ending with the second last Wednesday of the preceding month, and the holdings of till money which may be included in required reserves for the current month are fixed in the same way. Thus, the banks know at the beginning of each month the amount of Bank of Canada deposits they must hold on average during the month. Changes in their liabilities do not alter the required amount of reserves until they enter the formula in the following month. Moreover, the fact that they are only required to observe the minimum on the average of business days means that they may allow their cash to run low on some days and recoup by holding higher reserves on other days during the month. To quote from the central bank's submission: "The present view of the Bank of Canada is that the existing formula permits unduly slow responses and results in unduly large discontinuities in reserve requirements".[27]

Taking first the principle of a lagged calculation, it is in general true that no matter how one arrives at the figure for minimum required reserves the central bank is able to vary actual reserves in relation to the requirement at any time. If banks' assets and liabilities rise during a month, the requirement does not rise in step, but the Bank of Canada is nevertheless able to lower reserves relative to the requirement if it wishes to restrain or reverse the expansion. Whether the requirements rise automatically and reserves are held constant or the minimum is constant while actual cash is reduced, the reserve ratio falls at once and banks are brought under reserve pressure. They cannot delay their response because they must meet the requirement in the current month, and it is not obvious that they would respond more quickly under one system than the other.

Provided that it has up to date information on the banks' activities, the central bank can influence them in the direction it considers appropriate.[28] If chartered banks acquire bonds more rapidly than is considered desirable and the Bank of Canada hesitates to restrain the increase or reverse it, this really reflects a problem of conflict between the Bank's possible short-run objectives of stabilizing market yields or stabilizing particular quantities in the system: no cash reserve system can overcome such a conflict. Under a lagged or a current cash requirement, the crucial factors are the view of the banking institutions as to how difficult or easy the central bank will make it for them to meet the cash requirement currently and in the future and the central bank's willingness to accept the interest rate consequences of bringing quantitative pressure to bear on the system.

Thus we would argue that the use of a lagged requirement does not itself allow banks to escape the central bank's control. In view of the great difficulty banking institutions would have in compiling current deposit figures and the advantages of certainty about the requirement (since changes in cash occur in relation to a known minimum at all times), we believe that a lagged requirement should be maintained. As mentioned in Chapter 19, the minimum should be set above the level dictated by the banking institutions' business needs in order to ensure that they have a strong incentive to work close to the minimum and thus respond quickly to changes in the availability of reserves. At the same time it should not exceed this prudent minimum by too much for there is no point in calling for unnecessary amounts of non-earning assets.[29] We believe that the requirements recommended in Chapter 19 strike an appropriate balance.

The Bank of Canada has argued that response would be more precise if the averaging period were shorter because the banks would have less opportunity to offset low cash on some days with higher levels on others. They would therefore tend to work more closely to the requirement on

[27] Bank of Canada Submission III, paragraph 46.

[28] The fact that the Bank of Canada does not have current information on banks' participation in new issues does create problems, but it is the delay in receiving information rather than a lagged cash base that is at the root of the difficulty. See Transcript, page 7604.

[29] The power to vary the ratio is discussed later in this chapter.

each day than they do at present.[30] On the other hand, the chartered banks expressed the view that if the averaging period were shorter they would in practice have to work further above it than at present because they would have less time to achieve the required average level. The result might be that their responses would be less predictable than at present. It is also relevant that there is a monthly payments cycle for a great many transactions so that each bank has a pattern of cash flows which is completed within each month. If the reserve period were shorter, the discontinuities between one reserve period and another might well be greater.[31]

Changes from month to month in the deposits required at the central bank have ranged from $1 million to $45 million in recent years, with the largest ones normally occurring in February and March as a result of the regular seasonal movement in the note circulation over the Christmas shopping period. The Bank has entered into one month sale and repurchase agreements with the government in order to handle these predictable large changes in requirements. This technique, temporary shifts of government deposits between the chartered banks and the Bank of Canada, and changes in treasury bill holdings at the regular weekly auctions can all be used to alter the level of cash so that any necessary market transactions can be carried out over a number of days. Thus the central bank has the means of ensuring that even quite large changes in the monthly requirement are accommodated without disrupting securities markets. Since the Bank of Canada agrees that any problems with the time period of the present formula are not serious,[32] and since shortening the reserve period might lead to additional complications, we are not inclined to recommend any change in it.

The cash reserve requirements we recommended earlier should apply as at present to combined holdings of till money and deposits at the Bank of Canada. The chartered banks tend to hold about two-thirds of their reserves in deposits and one-third in currency, but we do not have comparable information for the other institutions. If the requirement applied only to central bank deposits, the change in the cash requirement each month would be somewhat less than under the present system. However, in the absence of information on which to base rough estimates of an equitable level of requirements excluding till money, and in view of the fact that the monthly changes under the present system are not so large as to be a nuisance, we have preferred to recommend inclusion of both till money and deposits in the minimum reserves. Moreover, inability to include till money in eligible reserves might discriminate against smaller or more remote institutions by forcing them to hold larger amounts of non-earning assets than larger institutions or those in major centres.[33]

We conclude, therefore, that the Bank of Canada's ability to bring about prompt and pervasive changes in financial conditions has not been weakened to any significant degree by inadequacies in the apparatus of cash control. Our view of the matter might be different if we felt it vitally important for the central bank to have precise day-to-day control over such quantities as the amounts of liquid assets held by banking institutions or the total of their deposit liabilities. However, we are persuaded that in working day by day to influence credit conditions the central bank should be more concerned to influence the movement of interest rates in the appropriate direction and prevent sudden random gyrations in the rate structure than to impose a particular short-run pattern of change in the amounts of particular assets and liabilities outstanding.

Needless to say, prices and quantities go hand in hand and the distinction between one immediate target of policy and the other cannot be rigidly drawn. Nonetheless, important consequences can follow from the choice between the two approaches. The financial system must be able to absorb sudden changes in market expectations, and if the adjustment were invariably taken up

[30] Transcript pages 7597-7599.
[31] Transcript, page 8065.
[32] Transcript, page 7958.

[33] It might also have the effect of encouraging institutions to economize excessively on till money, with possible adverse results, although this is rather unlikely.

by swings in interest rates, this would lead to confusion and uncertainty in domestic financial markets and to serious disturbance of international financial flows. For instance, in October 1960, the central bank reacted to the apparent failure of a long-term issue by putting sharp pressure on the system in an attempt to restrict the expansion of bank assets. As a result, interest rates rose very sharply at an inappropriate time and did not return to September 1960 levels for about a year. Even then, the apparent object of the policy adopted in October 1960 was not achieved for bank assets continued to rise. In October 1962, different circumstances faced the authorities with a similar choice between immediate price and quantity objectives. On this occasion the central bank supported the market with security purchases of some $111 million during three days and this action prevented the sudden eruption of the Cuban crisis from precipitating a similar distortion of credit conditions. Substantial excess cash reserves flowed into the banks temporarily but the central bank was able to reverse this gyration of the most crucial quantity in the system by reselling securities almost immediately. A week or two after the crisis hardly a trace of its passing remained.

These were both dramatic occurrences, but it is equally true that in more normal circumstances the central bank can facilitate its daily task and avoid creating unnecessary confusion by focusing its attention mainly on market prices. This involves watching to see what quantities emerge as a result of its own action impinging on all the other forces at work rather than attempting to lay emphasis on quantities and see what interest rates develop in consequence.

The management of the rates at which the central bank is prepared to act as lender of last resort to banks and money market dealers can assist in the task of maintaining stable market conditions or moving them smoothly and decisively as the occasion demands. Since June of 1962, the Bank of Canada has operated a dual Bank Rate system. The "official" Bank Rate at which it lends to banks is fixed by the Bank from time to time, while money market dealers may obtain funds under repurchase agreements at the lower of this rate and the "Money Market Rate" which is set ¼ of 1% above the average successful bid at the most recent treasury bill auction. Prior to 1956 there was only an administered Bank Rate, while from 1956 to 1962 the single Bank Rate "floated" ¼ of 1% above the treasury bill rate. The practical differences between these various techniques should not be exaggerated because the central bank has very close control over treasury bill rates: they do not move significantly unless the authorities initiate or acquiesce in the change. Changes in a floating Bank Rate thus provide an indication of the central bank's policy just as do adjustments of a fixed rate.[34] On the other hand, neither one can invariably be taken as an unambiguous signal of coming monetary policy.

In describing its use of the fixed rate during the past eighteen months, the Bank of Canada made a distinction between the occasions when a change in Bank Rate can be taken as a clear signal of intent—as when the rate was originally set at 6% during the 1962 exchange crisis—and the more normal circumstances in which Bank Rate changes reflect "gradual and tentative adjustments in the emphasis of policy rather than any major turning points in policy with unambiguous implications for the future".[35] Such gradual adjustments may be little more powerful as a signal than the changes in treasury bill and other short term rates which will already have occurred as a result of central bank action. However, the Bank went on to argue that the use of a fixed rate can assist in stabilizing and controlling market developments by setting a "tentative ceiling" on short-term rates.[36] Taken with its occasional use as a dramatic signal of changed policy, this seems to us a useful way of viewing the role of Bank Rate. It recognizes the useful function which occasional dramatic alterations can have in jolting

[34] In the extreme circumstances of August 1959, the control of the authorities over the bill rate was dramatically demonstrated by the decision not to accept tenders for all the bills offered. The result was an immediate adjustment of market expectations and interest rates.

[35] Transcript, pages 7475-76.

[36] Transcript, page 7656.

market psychology. At the same time, it recognizes that too frequent changes in Bank Rate can weaken its effectiveness and lead to confusion, or indifference, in financial markets.

However they are made, changes in the Bank Rate should be accompanied by as clear a statement as possible of the reasoning behind them. As several of our witnesses, including the Governor, pointed out, there is no virtue in the central bank confining its communications to a "curious system of flashes"[37] when more direct and understandable means are available. This is particularly the case because there are not the same formalized or conventional public reactions to Bank Rate changes in Canada as are found in the United Kingdom.[38]

In emphasizing the importance of focusing attention on interest rate developments, we are not suggesting that quantities can be disregarded: the two interact and combine to influence credit conditions and spending. Nor are we arguing that the maintenance of orderly markets calls for the central bank to set the entire pattern of rates by its operations in the market, although there is no reason to preclude the Bank from operating in any part of the market from time to time in order to help along the adjustments it wishes to achieve. This point has been sufficiently discussed in relation to debt management to make clear the reasons for our opposition to a "bills only" approach to open market operations. However, excessive central bank intervention throughout the market can be harmful. The markets in medium and longer-term issues are not as active as the short market: this can be an advantage when the authorities wish to move the entire structure of interest rates rapidly, but it also means that continual dealings in these thinner markets would be more disturbing than similar transactions in bills or short bonds.[39]

If the central bank were buying and selling longer issues every day, dealers would be less likely to make effective markets themselves and more likely to spend their time trying to anticipate the Bank's next move. In these circumstances, the market's usefulness in channelling funds efficiently from lenders to borrowers would be impaired and the authorities would to a degree be deprived of the reflection of underlying pressures and of information drawn from reaction to their own moves which a good securities market can provide. The point should not be over-emphasized, because however it operates the central bank is the main participant in the market and others are bound to be influenced by their view of the direction of its policy. Nevertheless, we believe that the central bank can normally carry out its function effectively by operating in the short market, and that it should enter the long market forcefully only when there are strong reasons for doing so.

We conclude that technical considerations such as the details of cash reserve arrangements or the manner of setting Bank Rate have not stood in the way of carrying out an effective monetary policy.

THE POLICY PROBLEM

There are more basic difficulties facing the authorities. Their first task, on which all else depends, is of course to determine what action is appropriate for the circumstances. To do this, they must analyse the current economic situation, understand the nature and strength of the forces at work and forecast with reasonable accuracy the strength and duration of future changes in the level of economic activity. Even the analysis of current events is difficult enough because the essential statistical information is available only after some delay. Thus, the results of labour force surveys are not available to the authorities until almost a month after the event, and there

[37] We are indebted to the late Sir Dennis Robertson for this phrase. He went on to say "this system does not work unless there is somebody to tell you what the flashes mean". Transcript, pages 5164-65.

[38] Many institutional lending and borrowing rates are linked to Bank Rate in that country. Conventions of this sort can be useful but they can also create undesirable rigidities in the rate structure and lead to inappropriate rate adjustments if the authorities wish to limit the impact of temporary measures to the short end of the market. On balance we think them undesirable.

[39] See for instance Mr. Thomas' remarks, Transcript, page 3786.

is a similar delay in preparation of the Consumer Price Index. Approximately twice this period elapses before information is available on such important elements in the emerging situation as industrial production, new orders and inventories and foreign trade, despite the fact that the authorities have access to some of these data shortly before they are published. We do not wish these comments to reflect on the excellent work of the Dominion Bureau of Statistics staff, who are well aware that the rapid production of less accurate statistics would serve no good purpose. Although any shortening of the time taken to prepare reliable data would be helpful, the fact remains that today's decisions must always be taken on the basis of information about the past behaviour of the economy.

If known changes in past economic conditions were an infallible guide to the duration and strength of an expansion or contraction, the authorities' job would still be comparatively simple in spite of the delays in obtaining current information. Unfortunately, the world is less certain than this and the authorities may fail to take action not because they are unaware of the current change in economic conditions, nor because of any administrative delays such as those typified by the widely spaced budgets of the fiscal authority, but rather because it is difficult to forecast economic conditions with sufficient accuracy to permit clear-cut judgments on the actions needed. Indeed, this is the only reason for delay because a change in the direction of market operations can be initiated immediately a decision has been taken. Whether one should describe such delays in establishing policy as lags in the response of the authorities or as an inevitable result of uncertainty about unfolding events, it is clear that they will always exist in some degree. Despite great improvements in statistical information and methods of analysis, forecasting is still an art in which informed judgment plays a major part. Forecasts need not be precise but they must give a correct view of the direction and underlying strength of economic developments if the authorities are to succeed in their main job of establishing the correct general set of policy.

In the absence of certainty, the authorities must decide in which direction they are prepared to err, given the general background against which they are operating. Thus, if the climate is generally buoyant and inflationary, they may decide it best to err on the side of restraint for a few months even though it may subsequently become clear that conditions are weaker than had been thought. Conversely, if there is a general climate of demand weakness and excess capacity, they may lean on the side of ease until events become clearer, but with the full knowledge that there is a fairly substantial risk of being wrong. These are not situations in which the choice is between extremes of policy, but rather between shades of emphasis designed to establish the appropriate policy climate.

Given the best economic analysis available to them, the authorities can only meet events with an appropriate policy if they have an informed view of the effects their action can be expected to have. This means that the central bank must have some notion of the magnitude and timing of the effects which changed credit conditions and the set of other policy instruments will have on real economic activity, a subject we discussed in the previous chapter. They must also know the effects which their own actions will have on credit conditions.

The authorities can of course observe directly many of the key components of credit conditions. Firstly, they have virtually complete current information on the level and structure of interest rates. In addition, each Thursday the Bank has up to date reports on the chartered bank's holdings of government securities and other liquid assets and full information on their assets and liabilities a week after the event. These main items of statistical information, which are published immediately, are supplemented by others, equally current, such as reports on "country bank" loans to the dealer market.[40] At the

[40] As mentioned in chapter 16, the "country bank" figures should be published each week.

same time, its continuing contacts with investment dealers bring the Bank of Canada a good deal of additional information on the behaviour of the central markets and the views of participants. All of this allows the Bank to see and to sense the response of the money market, the bond markets and the chartered banks to its own actions in the context of the other forces influencing them. Responses are quick and the immediate feed-back of information enables the authorities to take further action promptly in order to achieve their aims.

The description of central banking technique as a matter of "successive approximation"[41] or —as officials of the Federal Reserve phrase it— as a process of "probing" financial markets,[42] applies best to the behaviour of these central markets. This is the part of the system which is most immediately sensitive to official operations and for which the most complete information is currently available. Trials can be taken without delay and errors recognized while time remains to try again.

However, the links between central bank action and developments in other parts of the financial system are a good deal more tenuous, both because information on changes in other important components of credit conditions is much less complete and because the response to central bank action is slower and more diffuse. Despite excellent statistical reporting, the authorities' knowledge of chartered bank lending cannot be complete and up to date because so much depends on the policies adopted by head offices and the manner in which local managers and credit officers execute them. In view of the continuing close contact between the central bank and chartered banks, the problem is much less serious here than in other areas, although we were told for instance that the Bank of Canada sometimes finds that even the short delays before it has reports of chartered bank purchases of new issues complicate its task of assessing financial developments. Current statistical information on the activities of other financial institutions is much less adequate: monthly data on the receivables of sales finance and small loan companies and on the investment activity of large life insurance companies have for some years been compiled reasonably quickly, but it is only recently that quarterly balance sheets of the trust and loan companies have been available, while it is still the case that only annual data is available for the caisses populaires and credit unions, and that with a considerable delay.

In the securities markets, coverage of new bond and stock issues is generally good, but there has been no complete information on the important and rapidly growing commercial paper market. Our own survey makes a contribution to filling this gap and should be kept up to date and made more useful by collecting current information on a monthly basis. Similarly, the work now underway at the Dominion Bureau of Statistics towards preparation of quarterly balance sheet coverage of financial and non-financial companies will greatly improve the knowledge of developments in financial markets.[43]

In the absence of adequate statistics and close contacts beyond the chartered banks and main investment dealers, the central bank is not as fully informed on developments throughout the financial system as it ideally needs to be. Even with much fuller information, it would still face problems in deciding what its own action should be. Quite apart from the delays and uncertainty of real responses to changed credit conditions, the response of the financial system itself to central bank action is really a complex of reactions working itself out over time. For some crucial components of credit conditions, the delays are uncertain and can be quite long. "Successive approximation" thus has a quite different meaning when applied to the entire set of domestic credit conditions than it does in the close and sensitive

[41] See for instance Bank of Canada Submission II, paragraph 49, Submission III, paragraph 36 and Transcript page 7564 ff.

[42] Submission of Mr. Allan Sproul, page 4 and Transcript page 5633 ff.

[43] The preparation of statistical reports for government is already a costly burden on all the financial and non-financial enterprises which must provide the essential raw material for analysis. Every effort should be made to avoid unnecessary requests and duplication of reporting to different parts of government.

money and bond markets for which information is good and where responses are relatively quick. In the narrower context, the authorities can observe the response to their actions and, taking account of it, can press or relax their action in order to achieve the results they have in mind. This process is far from precise in a mechanical sense, but the authorities' influence is even less precise when it comes to the "set" of bank lending policies, the availability and cost of mortgage funds, the state of markets for provincial, municipal and corporate securities, the ease and terms on which consumers may finance expenditures and the many other channels through which financial conditions can influence economic activity. Current conditions are largely the result of past actions and in many respects cannot be altered rapidly, let alone set with any precision. The following review of recent changes in monetary policy and credit conditions illustrates the complex and variable patterns that unfold.

THE PATTERN OF CHANGE IN CREDIT CONDITIONS

One can go back and identify the intervals which have elapsed from the beginning of periods of restraint to the time when different components of credit conditions altered. If one takes the 1955-57 period as an example, the rate on treasury bills began to rise in February 1955, although it did not exceed 2% until the latter part of the year despite the rapidly-accelerating pace of business activity. Medium and long-term rates began to rise during the second quarter, the rate of increase of the seasonally adjusted money supply declined in August and the Bank of Canada report appearing some months later dated the adoption of a restrictive monetary policy at about that time. The Bank of Canada discussed the situation with the chartered banks in November 1955 and the banks then took serious steps towards a more restrictive loan policy. Despite continued pressure on the banks (including imposition of the 15% liquid asset ratio) and the adoption of more restrictive lending policies during the spring, seasonally adjusted bank loans continued to rise rapidly until mid-1956 and did not stop rising until 1957 when the economy reached its peak.

Meanwhile the N.H.A. rate, which had been reduced from 5½% to 5¼% in February 1955, was raised to 5½% in March 1956 and finally to 6% almost a year later, and rates on prime conventional mortgage loans edged up gradually from about 5¾% in the summer of 1955 to a high of 7% at the end of 1957. The relatively unattractive N.H.A. rate and cessation of bank mortgage lending led to a sharp reduction in the private flow of funds for new housing during 1956. In other parts of the capital market, similar changes were going forward throughout this rather extended period during which a restrictive policy was gradually imposed.

In the next period of restriction, increasing demands for funds began to move interest rates upward in May and June 1958. The rate of increase of the seasonally adjusted money supply dropped in October at the end of the Conversion Loan support period. Chartered banks began to run off their bond and other liquid asset holdings rapidly when the increase in their resources was brought to an end, and in the spring and summer of 1959 they adopted restrictive loan policies which contributed much to bringing the increase in their loans to an end in September. Once again the shifts to higher levels of interest rates and more restrictive credit policies elsewhere in the financial system occurred throughout this period of some 15 months.

Despite the fact that bond rates moved steadily upward from mid-1958 until October 1959, the prime rate on conventional mortgages held steady at about 6¾% until mid-1959 and then moved quickly up to 7¼% or slightly more by September: the N.H.A. rate was unchanged at 6% until December 1959 when it was raised to 6¾%. The private supply of new housing funds fell sharply in 1959 and again in 1960, although CMHC continued to lend generously until towards the end of 1959: its approvals remained low for about a year, despite the hesitant shift back to an easier monetary policy in 1960.

In the special circumstances of 1962, action was more decisive and events followed more quickly upon each other. The chartered banks' liquid assets did not rise after the end of 1961, in March they began liquidating treasury bills, and in early May 1962 interest rates began to rise. After the beginning of June, the banks sold very substantial amounts of bonds in addition to further liquidation of treasury bills, driving the entire structure of rates rapidly upwards. In late June, a fixed Bank Rate of 6% was announced. The external difficulties which led to this dramatic shift in policy eased quickly with the re-establishment of capital inflows, and the authorities were able—beginning in August—to move interest rates downward and ease the pressure on chartered bank resources. Because cash restraint and high interest rates lasted only for a short time, some of the components of credit conditions which are relatively slow to adjust were not significantly affected by events in 1962 as they had been in the protracted, although more gradual, earlier periods of restriction. Thus, a number of types of bank lending were little affected and there was no significant change in the cost or supply of mortgage funds. In the opposite circumstances of a short period of credit ease, one would also find that some components of credit conditions would be affected little if at all.

The pattern of change towards easier credit was not uniform on the two earlier occasions when restriction had lasted longer and pervaded the financial system. In late 1957 and early 1958, interest rates declined rapidly from the August 1957 peak, CMHC made loans of over $160 million in the last quarter of 1957 and the relaxation of restraint on bank lending appears to have begun early in 1958 under the stimulus of rising bank liquidity. A rapid change in credit conditions thus occurred in the last four months of 1957 as a result of a lowering in demands for funds and expansionary action by the authorities. In 1959 and 1960, the movement towards credit ease was much slower and less clear cut. Treasury bill yields declined from the peak of over 6% in August 1959 but were still over 5% at year-end and did not decline sharply until March 1960. Long-term yields levelled off in the latter part of 1959 but did not decline until early 1960. Meanwhile, the banks' liquidity ratios, which had reached their post-war low in the preceding period of loan growth, built up less rapidly than they had two years earlier and total assets did not begin to rise markedly until after the middle of the year. In these circumstances, the shift to an easier lending policy was more cautious than in 1958.

The authorities' hesitant monetary action contributed to uncertainty in securities markets which culminated with the failure of a long-term CNR issue delivered in October, 1960. Some speculative rise in bond prices preceded the unfortunate attempt to sell this issue, and subsequent lack of official support when the market weakened contributed to the sharp upward adjustment of rates in the securities markets referred to earlier. Conventional mortgage rates declined moderately from April to October, but the N.H.A. rate was held firm at 6¾% until late in 1961. Finally, as already noted, the supply of new residential funds actually fell in 1960 as a result of the cut in direct government lending at the end of the previous boom. Thus in this period, the change towards easier credit conditions came slowly and indistinctly, reflecting the mixed character of the actions taken by the authorities.

It is clear from this summary of recent developments that the speed and extent of changes in credit conditions depend in part on the decisiveness with which the authorities are prepared to act and the nature of the situation facing them. The decisiveness of policy changes in turn is strongly influenced by the authorities' view of the economic prospects. When all other considerations are overwhelmed by the pressing need for action to meet a serious problem, such as the exchange crisis in 1962, firm action can be taken. Experience in that episode has demonstrated that the necessary changes in interest rates and financial flows can be brought about very quickly indeed, especially if the banking system is fairly taut when vigorous restraint is first applied. On the other hand, if crisis does not stalk the land and policy

is directed more to affecting domestic rates of spending, and if the strength and probable duration of the expansion or contraction is not clear to the authorities, they may choose to act more gradually, following the situation as it develops and pressing their policy more vigorously or relaxing it as the prospects become clearer. This is the approach normally adopted by central banks: "if one knew in advance . . . what the situation was going to be six months from now, then some other method might be possible, but one doesn't know that: one has to be influenced by the development of the situation".[44]

However, the uncertainty of economic forecasts does not mean that the authorities should have no view of the underlying economic climate and of the appropriate direction of policy. They must make a choice as to the side on which it is better for them to be subsequently proved wrong, making gradual adjustments to this policy as events unfold. The response of the financial system will be correspondingly gradual, posing the danger that the full effects on spending will be felt only after the economic situation has altered. The authorities thus have the exceedingly difficult task of choosing between firm action based on forecasts that may well prove incorrect and gradual action whose cumulative effects may be strongest too late to assist in meeting the economic situation originally in prospect. Some have argued that the difficulties are such that discretionary monetary policy is more likely to contribute to short-run instability than to lessen it. While recognizing the problem and accepting the proposition that the monetary authorities cannot succeed in timing their policy to counteract every minor fluctuation in demand and output, we believe that discretionary policy can be helpful in preventing such cycles from becoming excessive.

The discussion of lags in this and the previous chapter can be summed up in the following terms. With some exceptions, the major sectors of the economy are sufficiently insensitive to minor changes in credit conditions that few changes in the decisions to spend occur before credit conditions have altered significantly. If—as in 1955-57 and in 1958-60—the authorities follow a policy of gradually imposing increasing restraint, they can probably expect six to nine months to elapse before the change in credit conditions has important effects on the decisions to spend of governments and corporations. The effects on economic activity in turn will be distributed through time; some being felt within a few weeks and others extending over a period of years. Our knowledge of the distribution of these effects is limited, but at least a further six to nine months is probably required to encompass a major proportion of the effects on employment and output. This means that if the authorities take the view that credit conditions ought not to be changed quickly in the direction of restraint, they must probably be prepared to wait for a period of a year to eighteen months before a major proportion of the effects on employment and output arising from changes in the decisions of governments and corporations have been realized. Some of the direct and indirect effects will be felt much later.

A period of a year to eighteen months, which it should be emphasized is a very rough estimate, is long relative to some of the periods of expansion we have experienced in recent years. But periods of expansion which are short and weak do not in any event call for significant restraint. The boom of 1954-57, with a duration of just under three years, is perhaps more typical of the type of expansion which will call for policies of restraint in the future. The lags in the system are not so long as to rule out a useful though limited contribution from a change in monetary and debt policies if the nature of this type of expansion is recognized in time.

While response to the 1955-57 and 1958-60 experiences of domestic credit restraint and ease was neither rapid nor decisive, the delays in adjusting financial conditions are not irreducible. The events of 1962 were admittedly unusual but they have shown that adjustments in interest rates and the structure of bank assets can be brought about very rapidly—perhaps more rapidly than was earlier thought possible. If circumstances had called for continued restraint, other components

[44] Transcript, page 7569—evidence of the Governor of the Bank of Canada.

of credit conditions would undoubtedly have been affected by central bank pressure on the system with considerably less delay than during the previous restrictive periods. It is reasonable, therefore, to expect well-executed financial policy to assist in stabilizing the economy. However its potential effectiveness may be reduced not only by the delays before spending responds to policy measures but also by limitations on the range through which credit conditions can in fact be varied.

LIMITATIONS ON THE AUTHORITIES' FREEDOM TO VARY CREDIT CONDITIONS

Only part of the difficulty confronting the monetary and debt authorities in exercising a stabilizing influence over the economy derives from lags in the flow of information, inability to forecast accurately and lags in the response of the financial system and the economy to changes in policy. Even if information were available earlier and if sufficiently accurate forecasts could be made of the strength and duration of fluctuations, it appears that the effects of monetary and debt instruments will be limited in the short run if confined to the range over which they varied in recent years. One obvious answer to this problem is that the short-run variation of credit conditions should take place over a wider range. Similarly, if longer-term developments can be foreseen accurately, significant changes should take place in the whole level of interest rates and the availability of credit to meet the new circumstances.

It bears repeating that an important part of the central bank's job is to prevent the development of financial crises: it must try to keep credit conditions within the range where markets can operate effectively if the economy is not to suffer the disruptions of financial panic. This is best seen not as a limitation on its freedom but as a positive objective of policy. Bearing this point in mind, what are the limitations which prevent the use of the instruments of policy over a wider range than we have experienced?

One limitation is the difficulty of altering market expectations in the absence of a major change in economic circumstances. Borrowers' and lenders' views about the level and structure of rates are based on their assessment of the basic forces at work in the economy as well as their judgment of the authorities' probable course of action. It is by no means easy to shift credit conditions in a direction or to a degree which markets do not feel to be in accordance with their view of the economic outlook. In most circumstances this does not pose an insuperable problem because the authorities will in fact not be trying to lower interest rates when the economy is under pressure or vice versa. Thus most of the time it is appropriate for the authorities to "reinforce or mitigate" the impact of underlying forces on interest rates (the Bank of Canada's phrase already cited).

In another passage cited in Chapter 21, Sir Dennis Robertson went somewhat further in saying that the central bank should "influence the rates . . . in a direction and a degree consistent with the long-term forces operating in the economy". If the long-term forces call for a policy not obviously in line with immediate economic circumstances, problems can arise. Efforts by the authorities to take account of lags in the impact of their measures and to move credit conditions in anticipation of the future economic situation are likely to have quite limited success. If all the current indicators of economic activity are still rising, it may be difficult to persuade markets that the time has come to shift to an easier policy to meet a coming recessionary phase. Even when the changed economic situation is generally evident, resistance to attempts to lower rates may persist.

The conventional instruments of policy have traditionally been capable of bringing about sharp reductions in short-term rates of interest, but major downward shifts in long-term rates over a short period are virtually unknown in most countries in the absence of a basic change in underlying conditions such as the great depression of the nineteen thirties. For instance, holders of long-term securities will not normally assume that long-term interest rates can or will change from over 5% to under 3% and remain at the new

low level. If rates begin to move downwards towards 4%, holders of long-term securities will begin to realize on their assets on the assumption that such securities will likely be available in the near future at yields close to 5%. If the authorities wish to achieve a major downward movement of interest rates, they will ordinarily have to follow a policy of persistent ease over a considerable period. The extent of a reduction of long-term interest rates which can be quickly achieved is thus fairly limited unless the authorities are prepared to take the risks of wholesale liquidation which might be associated with an attempt to peg bond prices at a level regarded as completely inappropriate by the market.

The Bank of Canada drew attention to one of the dangers of such a policy: "The central bank will be very conscious of the limitations which it will face in attempting to keep the more liquid situation under control later on. This may be particularly true if it feels that the possibility of the reappearance of inflationary pressures is not too remote, and if it is not confident that adequate support from other public policies will be forthcoming at a later stage".[45] On the first point, it must of course be said that if the recession is expected to give way shortly to renewed excess pressure on the economy, a policy of extreme ease would in any case be inappropriate. While recognizing the practical difficulties of bringing all government policies to bear quickly on the ensuing inflationary situation, we can only urge that as far as possible they be continuously coordinated in support of each other.

Attempts to bring about wide fluctuations in interest rates and credit conditions may run into other domestic limitations. There may be hesitation to alter security prices so drastically that dealers and financial institutions are disrupted. An excessive concern for the stability of asset values need not stand in the way of vigorous policy: experience has shown that institutions and markets are well able to withstand very substantial shocks, although this is not to say that policy should ever deliberately court the danger of provoking crises. Lack of public acceptability of tight money is more likely to inhibit the government, and even the central bank itself. The problem is a real one, particularly since some borrowers are affected more severely than others. Much can nonetheless be done to obtain support for policy, and to overcome the resistance to changes in interest rate levels caused by market expectations, if the authorities take pains to inform the public of their view of the economic situation and the reasons for the policy being followed. We do not envisage the central bank or others in government always being in a position to give clear and unambiguous 'signals' of each change in policy—or always finding it desirable to do so. However, a continuous effort should be made to keep the country informed of their assessment of the underlying economic situation so that adjustments in the set of monetary policy will be more readily accepted.

Despite the authorities' best efforts, these domestic limitations on changes in interest rates and in other components of credit conditions will persist to some degree. However, they are less important than the constraint of our international position which, under present arrangements, is very likely to impose even narrower limitations on interest rate changes than the other factors would allow.

Canada is more than most countries closely integrated into capital markets abroad. There can be, and have been, short periods in which the short and long-term yield differentials between Canada and the United States have increased or decreased without consequential short-term effects on the exchange rate and on exchange reserves. However, attempts to widen the range of variation of interest rates far outside the range of variation prevailing in other capital markets, particularly in the United States, are likely to promote large-scale movements of capital. The authorities in this country can attempt to raise the interest rates to be paid by provinces, large municipalities and large corporations, but if rates in the United States and other external capital markets are significantly lower, they cannot succeed in making most major borrowers pay the Canadian rates. In the absence

[45] Bank of Canada Submission II, paragraph 73.

of other measures, very high rates will likely lead to a massive resort to external borrowing and, depending upon the exchange rate system in use, either to an appreciation of the exchange rate or the large-scale accumulation of exchange reserves.[46] Any attempt to achieve very low rates will tend to lead to the opposite result—exchange rate depreciation or loss of reserves. On occasion, these may be precisely the results which are desired, but it is clear that domestic changes in credit conditions can never be considered in isolation from their likely effects on international capital movements. It follows that if there are limits to the changes in the exchange rate or to the gains or losses of international reserves which are regarded as acceptable, then these limits also apply to the range of variation of domestic credit conditions.

WIDENING THE RANGE OF VARIATION OF CREDIT CONDITIONS

Our analysis in this and the previous chapter points up the difficulties in using conventional monetary and debt policies to make a major contribution to the domestic stabilization of the economy, particularly over short periods. The conventional instruments of policy, even if appropriately used, have limited effects on expenditure within the range experienced in the post-war period. If used over a much wider range, either in the short or longer run, they would have larger effects. However, there are limits to the possibility of extending the range of variation of credit conditions, particularly because of international considerations. Thus, if interest rates are raised or lowered substantially within Canada in relation to the rates prevailing in external capital markets, the effect will be largely to redirect borrowing rather than to curtail or increase it. If a change in reserves or an alteration of the exchange rate is desired, then clearly this redirection is a desirable by-product of the action. If, however, a substantial change in domestic credit conditions is urgently required, devices which widen the range of variation without at the same time leading to excessively large swings in interest rates and the exchange rate or reserves might be brought into play.

If the availability or cost of some types of credit can be directly influenced, and markets are somewhat imperfect so that the borrowers affected are in practice not able to find funds elsewhere by bidding up interest rates, direct action on some credit channels can strike quickly at vulnerable sectors of the economy. To take an example, a variety of measures discussed below may be used to induce the banks to restrict their lending. If the rates charged on bank loans rise rapidly in response to the use of devices of this kind, the customers who decide to forego bank borrowing may be largely those with other alternatives. Their demand will merely be redirected and interest rates will rise throughout the system. Under these circumstances, the results are essentially similar to those which would have occurred if the banks had been left free to adjust the structure of their assets as they wished. If the rates charged on bank loans do not respond to direct controls because of legal or other constraints, the rationing of bank loans will be done by non-price measures, and again if the bank customers who are refused loans can turn to other parts of the capital market and obtain finance by bidding up interest rates elsewhere their spending will not be curbed by much more than would have been the case if the direct measures had not been applied. If, however, some bank customers who are refused loans in either instance do not seek, or cannot find, accommodation elsewhere at acceptable rates, credit flows and expenditures will both be reduced without the full effect of the restraint being reflected in interest rates.

To the extent, therefore, that these direct devices reduce availability of credit with a dampened effect on interest rates, they permit a widening of the range of credit conditions while imposing a burden on particular institutions and

[46] The existence of such measures as the proposed U.S. interest-equalization tax may moderate Canadian external borrowing in such circumstances, although this would not be true if the interest differential exceeded the tax by a wide margin. Moral suasion by the Canadian authorities may also check such borrowing.

particular borrowers.[47] The more perfectly the financial system functions, that is the more changes in the availability of credit anywhere are reflected in interest rates everywhere, the less opportunity there is for reducing credit availability to some borrowers without this being fully reflected in interest rates. In short, devices of the kind discussed below can be viewed as techniques which use or create market imperfections for the purpose of achieving significant effects on expenditure through reduced availability of funds rather than higher interest rates.[48]

Before discussing a few of the direct measures, we should state our view that they should not become a regular part of the apparatus of control but be reserved for extreme situations. The general credit instruments used intelligently can contribute usefully to stabilizing the economy and at most times they and other general policies can bring us as close to achieving our economic objectives as it seems reasonable to expect. Direct intervention in financial markets can disrupt them unnecessarily and may in the long run inhibit the best development of the financial system. Moreover, such measures can be very difficult to administer and, if used regularly, are likely to become less and less effective as borrowers find ways to circumvent them. As the Governor of the Bank of Canada said to us "Markets will not accept the imperfections".[49] The financial system will adapt, ways will be found to make funds available when the normal channels are stopped and the authorities will then be endlessly building new dams where the new flows have appeared. As an example, the large sales finance companies were little affected by restriction of their bank loans for they were able to turn increasingly to the money market for funds.

However, occasions will doubtless arise when as a result of errors of forecasting, inadequate use of the general instruments or sudden, unpredictable occurrences the authorities are faced with a pressing need to restrain credit flows decisively. Since a general increase in the cost of credit does not have a sufficiently strong and rapid effect on spending, the authorities will be faced with a dilemma: either they must interfere with free markets which allocate resources equitably and efficiently or they must sacrifice in part the objective of stabilizing the economy. It may then be better to accept the costs and inequities of direct measures than to allow excess demand pressures to run unchecked.

(i) *Administrative Control of Institutional Lending*

The devices which lie closest to our own experience are controls over the banking system. These may be written into the legislation to give the central bank standby powers to be used only with government approval. Alternatively, effective control over the institutions may be based on agreements with them when need arises, rather than on any formal powers. Provision is already made in existing legislation for variation of the banks' cash reserves from 8% to 12%, subject to a month's notice for each change and a limit of 1% a month on increases in the ratio. In other words, the Bank of Canada can raise the requirement from 8% to 12% over a period of four months.

This technique may be used to freeze increases in reserves when the authorities cannot accept the interest rate consequences of putting selling pressure on the securities markets, for instance when the problem at hand is one of financing excessive inflows of capital from abroad. Whether used in these circumstances, or as a device for controlling loans by reducing bank liquidity, the effect is to impound a higher share of assets in a particular form. We do not believe it a particularly useful instrument for either purpose. If speculative

[47] The main impact is likely to fall on medium-sized and small borrowers with few alternative sources of finance. We noted in the previous chapter that the effect of such measures will be blunted to the extent that the authorities urge the banks to discriminate less severely against these borrowers: those with ready access to alternative sources of finance, such as the money and securities markets, will not be seriously affected by curbs on bank loans to them.

[48] Professor Erik Lundberg discussed general and direct monetary measures in these terms in his article "Economic Stability and Monetary Policy", *Skandinaviska Banken Quarterly Review*, No. 1, 1962.

[49] Transcript, page 7553.

capital inflows must be financed and ultimately checked, the power to force banks to raise their lending to government by some $600 million gradually over four months may not prove prompt or decisive enough to meet the situation. If the object is to check bank lending in extreme circumstances, the instrument—although sizable in relation to the banks' cyclical portfolio adjustments—is unnecessarily cumbersome.

Essentially similar results could be achieved by variations in bank liquid asset ratios with the difference that the banks would earn a return on the assets impounded. Since 1956, the chartered banks have agreed to maintain a minimum liquid asset ratio of 15% of deposit liabilities on a monthly average basis. This is made up of at least 8% in notes of and deposits at the Bank of Canada and the remainder in additional cash and in day-to-day loans and treasury bills. As with the cash ratio, there has been no variation in this ratio since it was first introduced. In the chapter on chartered banks we expressed the view that this agreement with the Bank of Canada is of limited use as an instrument to control bank lending and does not contribute significantly to a more orderly adjustment to cash reserve pressure.

If the authorities do urgently need to restrict bank lending through direct control of bank liquidity, they must reach further into the portfolios of liquid assets. The Bank of Canada has indeed suggested that a variable liquid asset ratio would be a useful supplement to its ordinary techniques of control.[50] If it were to be useful, however, the authorities would also have to be given the power to vary it more widely than the present cash ratio, although presumably within specified limits, and to impose the changes more quickly.

The system of "special deposits" used in some countries is essentially the same as the use of a variable cash reserve requirement. The banks can be required to deposit funds with the central bank over and above normal requirements and these special deposits can be released to them when economic conditions alter. If a similar control is exercised by requiring the banking institutions to invest in non-marketable government securities, the special issue is similar in effect to raising the liquid asset ratio of the banks.

These devices are designed to limit the adjustment of bank portfolios by increasing the minimum amounts of particular assets which must be held. Another device for limiting this adjustment is the imposition of a ceiling on the increase of other assets, in particular bank loans and non-government securities. A step of this kind was taken in Canada in February 1951 when the banks agreed that "further expansion in total bank credit was undesirable". There was no net increase in bank loans and investments other than Government of Canada securities in the last nine months of 1951. Considerable use is made of direct bank loan restrictions in Holland, where the central bank is unable to engage in extensive open market operations.[51]

These last practices are examples of the use of "moral suasion", to which all central banks resort from time to time. In circumstances when the national interest is clearly involved, the authorities can request financial institutions or other private interests to adopt particular policies. Their success depends on the clarity and force of the case presented by the authorities: with rare exceptions Canadian experience has been that the banks and others will co-operate in the national interest if reasonable arguments are advanced. However, knowledge that the authorities have the power to enforce their wishes doubtless strengthens the appeal, and it can be argued that the main purpose of legislating the power to impose a liquid asset ratio would be to provide a sanction behind the authorities' less formal attempts to elicit co-operation.

There is a danger, however, that the power itself or persuasion by the authorities will be used unnecessarily to impose a particular pattern of investment on private institutions or as a means of providing a captive source of finance for the government at the expense of other bor-

[50] Transcript, pages 7608-7615.

[51] Submission of Dr. Marius W. Holtrop, President of De Nederlandsche Bank N.V., and Transcript, page 4137 ff.

rowers. Quite apart from this sort of abuse, there is likely to be less meaningful discussion with the private institutions and less pressure on the authorities to formulate and defend sound policies if they have the power to impose their will without the private debate which must accompany less formal moral suasion. Moreover, emergency devices such as a variable liquid asset ratio may become a permanent part of the machinery, with the authorities relying increasingly on their ability to control what may not be the crucial credit flows in the system and being the less careful and adept in using the general instruments.

Moral suasion may be directed to purposes other than the restriction of bank lending, although this has been its most common use in Canada. For instance, the Bank of Canada has held discussions with insurance companies, sales finance companies, department stores, stockbrokers and investment dealers with a view to obtaining agreement on policies to be followed. Agreement has not always been achieved, sometimes because the need was not evident to the institutions concerned, sometimes because the channels of discussion had not been well established.

Agreements are more likely to be reached if the central bank keeps in regular contact with the institutions concerned: those who hear from the central bank only when it wants them to do something against their own interests are unlikely to understand the authorities' problems or to feel that their own are appreciated. Even if there is close contact, moral suasion cannot be relied on to carry much of the weight of policy in normal situations because market participants cannot be expected to act against their own interests except temporarily and in exceptional circumstances. As Mr. Towers put it: "In the final analysis, over-all monetary and fiscal policy must do the job. But I believe there can usefully be some rare, temporary and prudent exceptions to this rule".[52] When exceptions are made, they should carry the approval of the Minister and the terms of agreement reached should be made public unless there are overwhelming arguments in the public interest for keeping them secret, as might, for example, be the case during an exchange crisis.

We are not persuaded by the evidence before us that any legislative power to direct the allocation of the institutions' funds is necessary. These are in the main emergency measures, and if the authorities' case is well founded, co-operation will be forthcoming. If the authorities, however, find themselves handicapped in operating by the lack of specific legal powers, we would have no particular preference between a variable liquid asset ratio and some statutory authority to control loan increases. However, we do recommend that if any such power is written into law its use should require the specific approval of government. The Bank of Canada might impose a restriction but it should lapse in perhaps a month unless endorsed by government and tabled in Parliament.

(ii) *Selective Credit Controls*

Another set of devices which can be used to widen the range of variation of credit conditions with dampened effects on interest rates are selective credit controls. These controls are directed to types of lending rather than to the lending of particular institutions. For example, our existing arrangements for housing finance have frequently had effects essentially similar to those resulting from selective credit controls. The government provides relatively favourable terms for purchasers and builders of new housing by guaranteeing mortgages. If this N.H.A. lending is curbed—either in the automatic way described in the previous chapter or more consciously by raising down payments and shortening the term of the loan—it imposes a sharp change in the terms and conditions of borrowing facing builders and purchasers of new housing. A major increase in the down payment requirement and a shortening of the term of repayment are precisely the changes which are thought to be of particular use in affecting the expenditure of consumers on housing and durable goods. In this sense the existing arrangements for financing housing expenditure, which lead to sharp reductions in pri-

[52] Submission, p. 9.

vate N.H.A. lending in periods of restraint if the N.H.A. rate is not raised, and which thus force borrowers into the less favourable conventional market, have a built-in tendency to operate in the same way as consumer credit controls. While believing that there are compelling grounds for allowing the N.H.A. rate to be set free to vary with market rates, we have also suggested that the down payment requirements and maximum term of loans could be altered from time to time in line with the needs of stabilization policy. In extreme circumstances the authorities may also wish to fix the rate for short periods in order to reinforce their policy: thus the possibility of using selective controls on housing will not be lost to the authorities, but they will be required to use them as a matter of conscious policy rather than relying on the fortuitous effects of present institutional arrangements.

Consumer credit controls also depend for their effectiveness on the inability or unwillingness of consumers to find alternative sources of finance to provide the higher down payments and the shorter terms of repayment which would be required under such controls. If alternative sources can be readily found by consumers, the attempt to block up one channel of lending will merely encourage the widening of another channel and the effect will be felt quite fully on interest rates. Similarly, to the extent that controls over instalment finance lead to the development of organizations which purchase and lease durable goods, demand has not been curtailed but merely re-directed. There is also a danger that lenders will evade the restrictions by writing inflated cash values for trade-ins into their contracts and employing other stratagems with the collusion of their customers. As we have mentioned earlier, this is a problem likely to arise from repetitive use of the instrument. Whether used periodically or infrequently, control over consumer instalment finance poses severe problems of adequate administration. In this country there is also some doubt as to the federal government's authority to impose them. In any event the imposition of special excise taxes on consumer durables (which strike at all consumers, not just those who borrow) may be just as effective in curbing consumer spending, especially if they are thought likely to be withdrawn in the fairly near future.

Direct credit measures can also be used to exert a stronger influence on business spending, and it can be argued that they are more appropriate than attempts to control consumer spending because of the wider cyclical swings in business investment. Going beyond control of bank loans, the authorities may ration the flow of funds from securities markets by imposing control over new capital issues. This is a drastic measure and experience in other countries has shown that it cannot be administered easily. Priorities must be established, account must be taken of alternative sources of funds, including foreign markets, of flows among associated companies and of the fact that a great many companies draw most of the funds they need for capital expenditure from internal sources rather than from the capital markets. In view of all the difficulties and disadvantages of the direct intervention by government in the process of allocating funds among individual companies, we find it difficult to imagine circumstances which would justify capital issues control.

Techniques of varying the effective cost of funds to firms by the use of various fiscal measures will be described in a later chapter. Less dramatic effects may be achieved by altering the taxation rules regarding the deductibility of interest on borrowed funds, but this has not proved either equitable or workable in countries such as Australia where the technique has been used: many companies were not affected at all, while others were so seriously harmed that wide-scale exemptions had to be made.

CONCLUSION

These direct measures should be called into play only when all else has failed and an emergency justifies the disruption and costs of drastic action. Even the general instruments are bound to affect some people more than others, but the authorities must not be restrained by excessive

tenderness; if any type of stabilization policy is to be effective, someone must be affected. So long as markets are reasonably good, it is probable that the marginal, less credit-worthy, less productive types of expenditure will be affected more severely than others by a restrictive policy applied to the system as a whole. In any case, there is no assurance that those administering direct measures would be better able to select the expenditures which should go forward and reject those to be deferred or cancelled. Yet it should be recognized that there is a conflict between the long-run objective of developing sensitive and flexible financial markets that will allocate resources well among competing uses and the need to stabilize economic activity with measures that work fairly quickly. The more adept the markets become at moving funds with comparatively little change in interest rates to those wishing to use them, the less one can count on imperfections and the additional cost and inconvenience of borrowing standing in the way of real expenditures.

Whatever techniques are used, there is no way of making the job of the monetary and debt managers an easy one. They must always operate with limited information against a continually changing series of financial and economic events, and it will remain a matter of judgment as to how far they can or should try to moderate or reinforce these unfolding trends with their own actions. The underlying realities and public attitudes shaping credit conditions will impose limitations on their freedom, and the international environment may further inhibit their ability to vary policy over a wide range. Even with prompt information and excellent forecasting, the delays in making their actions effective on credit conditions and the lag between this point and the impact on real spending will limit the contribution which any policies—conventional or unconventional—can make to stabilization in the short run. This contribution will be greater if the authorities take account of the longer-run forces influencing the economy in the broad set of their policy approach to more immediate events.

Despite the limitations of monetary policies, the emergencies justifying direct intervention in market flows should be rare, if the other arms of policy are properly used, and debt management is well co-ordinated with monetary measures. The limits of what can be expected from the general instruments of credit policy alone must nevertheless be recognized. Their impact can be hastened by concerted official action, and the range of variation can be widened somewhat by appropriate combined use of monetary and debt measures, but it remains true that at the best one cannot expect credit policy alone to stabilize the economy. This is not primarily a matter of the techniques used. Rather it results from the comparatively limited effect of any reasonable or feasible change in credit conditions on real expenditure. While such changes in credit conditions can make a worthwhile contribution to stabilization, it is clear that even the most imaginative and appropriately executed monetary and debt policies will not allow the country to achieve, or even approach, its economic goals unless other instruments of government policy are also brought into play.

CHAPTER 23

INTERNATIONAL FINANCIAL POLICY

There are few countries of the world today in which international considerations do not play an important part in domestic economic policy decisions. Over the post-war period many of the barriers to the flow of trade and capital have been removed or lowered and the international connections among domestic financial systems have been strengthened. Changes in financial policies can now have rapid effects on international flows of funds and recognition of this exercises an influence over the policies of countries large and small.

Moreover, all countries which buy and sell in markets abroad must ensure that policy is aimed at keeping their costs competitive if they are to earn the internationally-acceptable money needed to pay for imports. In this respect, countries are like individuals, being able to spend only what they earn or are able to borrow from others; (both can, of course, in the short run, also run down their external financial assets to the extent that they have them). Similarly, a nation's capacity to earn income or to borrow, like those of an individual, depend upon its skills, willingness to work and the efficiency with which it uses its resources. International lending and borrowing can be just as productive and useful as domestic lending and borrowing, but if carried on over a long period on a major scale relative to income can also create concern about the difficulties which may be associated with servicing a large external debt.

The fewer and lower the barriers and restrictions to the free flow of trade, capital and labour, and the more closely a nation is integrated into the international economy, the more necessary it is that international considerations play a part in all policy decisions. While membership in the international community sets some limits to the policies which can be pursued by individual countries, the net advantages derived from international specialization are very great. As with individuals, reductions in the degree of economic interdependence could lead only to higher production costs and a drastic reduction in the attainable standard of living.

Canada is *par excellence* an example of a country which is closely tied in a variety of ways to the rest of the world, and its financial, trade and other links with the United States in particular make for a uniquely close relationship between the two countries. This close relationship is on balance of great advantage to Canada, but it does mean that changes in U.S. policies or investment attitudes which may not be of major importance in the huge framework of the U.S. economy can on occasion have very big effects on Canada and pose substantial difficulties for Canadian economic policy.

Given this high degree of economic interdependence, there is a sense in which all financial policy in Canada is to a greater or lesser extent international financial policy. There are, however, a narrower range of international issues including exchange rate policy, other policies to influence

the balance of payments and policies connected with world payments arrangements, on which we shall focus our attention in the present chapter.

In the course of our discussion we shall be comparing the present exchange rate system with the flexible exchange rate which Canada has had in the past. The purpose of this analysis is to isolate fundamental factors influencing Canada's international financial policy and to assess the implications for general economic policy of the adoption of a fixed exchange rate. We wish to make it clear at the outset that we do not advocate any change in the existing exchange rate system: the fixed rate is at a level that seems appropriate and the system is working well.

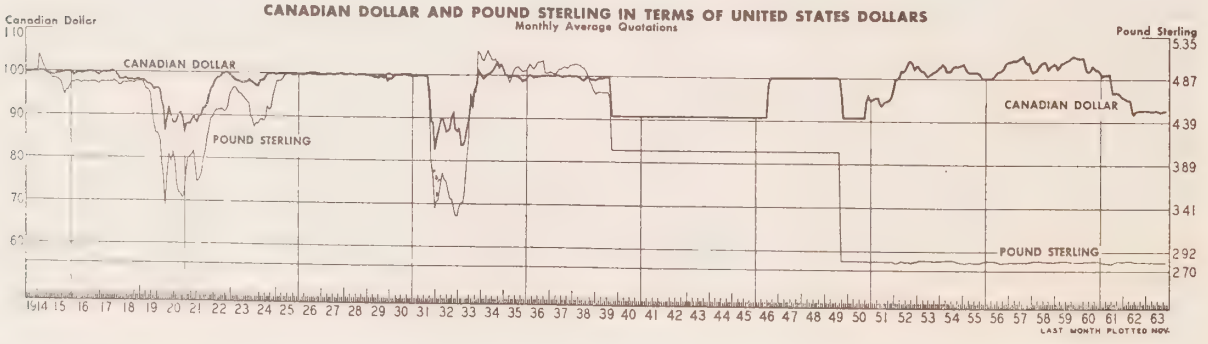
THE CANADIAN EXCHANGE RATE BEFORE 1950

Over the decades, Canada has had considerable experience with both a fixed and fluctuating exchange rate. Prior to 1914, the Canadian dollar was fixed in terms of gold and, therefore, fixed in terms of all other major currencies. The international gold standard, which because of the then dominant position of Britain might more accurately be called the international sterling standard, was a workable arrangement, and the Canadian economy adapted to some very substantial changes in capital flows and trade within its framework. While in some respects it was like present exchange rate arrangements, the problems we confront and the means of dealing with them have changed, not least because of the increased responsibility for economic management which has been assumed by national governments. It was easier for governments to accept a fixed relation between gold and national currencies as the principal (and sometimes the only) objective of monetary policy when they were not expected to assume a major responsibility for national employment, productivity and prices.

For most of the period 1914-39, Canada had a fluctuating exchange rate. Canada went off the gold standard in 1914 and did not return to it until July, 1926: even then we remained on it only until January, 1929. As indicated in Chart 23-1, the fluctuation of the Canadian dollar was kept within narrow limits throughout most of the inter-war years, except during the periods 1919-20 and 1930-33. The fact that Canada was only on a fixed rate for two and a half out of twenty-five years could be taken as strong evidence of the difficulty of maintaining such a system in this country, but although this experience is by no means irrelevant, it is noteworthy that most other major currencies were also flexible for much of the period. Severe economic fluctuations and the inadequacies of the international payments system made the maintenance of fixed rates a world rather than simply a Canadian problem.

During the war years the value of the Canadian dollar was fixed at a 10% discount relative to the United States dollar and there was a comprehensive system of exchange control. In July, 1946 the Canadian dollar was revalued to parity with

Chart 23-1



the American dollar, in part to insulate the Canadian economy from the rapid price increases following the removal of controls in the United States. This exchange rate was maintained for over three years in spite of serious balance of payments difficulties in 1947 and early 1948. Though the rate was appropriate in terms of price and cost relationships, the unexpectedly heavy drawings of the United Kingdom and European countries on Canadian reconstruction loans and other demands put upon an overburdened Canadian economy led to a decline in the Exchange Fund's holdings of gold and U.S. dollars from $1,667 million at the end of May, 1946 to $480 million at the end of November, 1947.[1] Emergency assistance was obtained from the United States Export-Import Bank and import controls and special excise taxes imposed. The reserves recovered fairly quickly and by the end of 1948 totalled just under $1 billion. In September, 1949 there was a 30.5% devaluation of sterling in terms of the United States dollar accompanied by devaluations on the part of many other countries. A decision was taken to devalue the Canadian dollar by 9% in order to protect Canada's competitive position and balance of payments. Following this devaluation, little change took place in the reserves for some months, but in the middle of 1950 a substantial speculative inflow of capital developed which added just under $500 million to the reserves in August and September. With two attempts at setting the exchange rate having yielded little success, the decision to free the exchange rate was announced on September 30, 1950.

THE FLEXIBLE EXCHANGE RATE 1950-1960

Immediately after the withdrawal of the official buying and selling rates, the Canadian dollar appreciated sharply. Following some weakness in the first half of 1951 it resumed this movement in the latter half of 1951 and broke through parity with the U.S. dollar in March, 1952 to a premium of 4% in August. The total appreciation from September, 1950 was 14 cents but from mid-1952 to the end of 1960 the exchange rate stayed within fairly narrow limits—the total range of fluctuation amounting to about five and a half cents. Although the rate was flexible, it could not be described as unstable.

If there had been no major changes in the Canadian balance of payments during this period, the simplest explanation of this stability would be found in the economic conditions of the period. There were recessions in a number of major countries during these years, but they were much less severe than the pre-war contractions, and not completely in phase. Thus, when cyclical declines occurred in the United States, the continued advance of the Western European economies, our second major market, provided a partial cushion for Canadian exports. The maintenance of favourable world economic conditions, and some fortuitously anti-cyclical movements in agricultural exports, is reflected in the basic stability of all exports shown in Chart 23-2. During these years also, as in others, the Canadian and American economies tended to move together and there was a similar parallellism in the economic policies followed by the governments of the two countries.

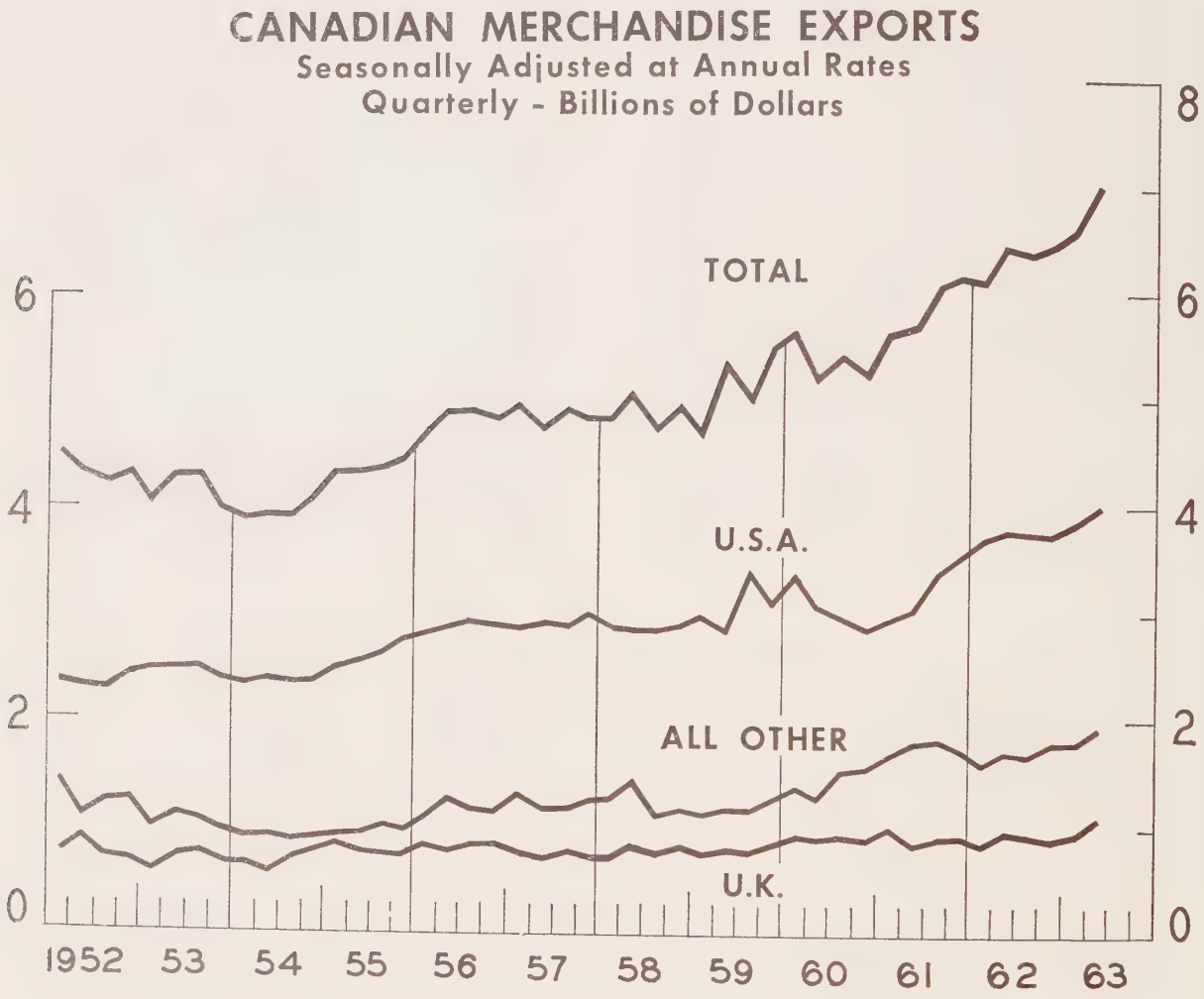
Under these conditions it could be argued that there were unlikely to be major stresses and strains on Canada's balance of international payments and that stability of the exchange rate was precisely what might have been expected. This reasoning, however, assumes that no major shifts occurred in the Canadian balance of payments, and this was clearly not the case. Between 1953 and 1957, the Canadian current account deficit increased by over a billion dollars from $440 million to $1,455 million, declined by over $300 million in 1958, increased by $370 million in 1959 and fell again by $260 million in 1960. These are large changes, and broad economic stability obviously is not the full explanation for the exchange rate stability of this period. To understand the forces at work some reference is required to the mechanism of adjustment under a flexible exchange rate.

[1] Had the exchange rate been flexible, it would undoubtedly have fallen sharply in 1947 and recovered in 1948.

Under balance of payments accounting, deficits on current account are necessarily matched by surpluses on capital account and vice versa. The question then arises as to how, with such limited adjustments in the international value of the Canadian dollar, the current and capital accounts were kept in balance. There are three possible explanations—first, that this was achieved through changes in the official reserves; second, that the factors determining the size of the current deficit and the capital surplus were such as to induce offsetting changes in these accounts without exchange rate movements; and third, that limited changes in the exchange rate affected the current or capital accounts or both in ways that quickly brought them into balance.

The official reserves were not used during the period 1953-60 to prevent persistent movements in the exchange rate. The policy of the Exchange Fund was one of correcting or preventing disorderly conditions rather than interfering with basic trends, and it intervened in the market only to prevent substantial movements in the exchange rate within any given

Chart 23-2



trading day or from one day to another. There were, of course, occasions when this policy required the Exchange Fund to be a net buyer or seller continuously for several months. When a movement in the exchange rate became pronounced, however, there is no evidence that the Fund attempted to stop it. The limited part played by the Exchange Fund in the period 1953-60 is indicated by the fact that changes in the official reserves from month to month from December 1952 to 1960 were below $20 million in 59 of the 96 months, from $20 million to $50 million in 31, from $50 million to $100 million in five, and only exceeded $100 million in one of the months during the period. Over the period as a whole, the highest month-end reserve figure was only $233 million above the lowest holding recorded.

If official reserve operations did not play a major part, the second possibility is that changes in the capital account and the current account were related in such a way that a balance was achieved without the necessity of major movements in the exchange rate. Changes in these accounts do not just happen; they arise out of a set of economic conditions, and if these conditions were to produce capital account surpluses and current account deficits simultaneously they clearly provide part of the explanation.

An economy is ordinarily not the recipient of substantial foreign direct and equity investment unless economic prospects are favourable and long-term profit expectations high in relation to alternatives in other parts of the world. Similarly, the flow of long-term debt capital will be towards the country in which interest rates are high in relation to those offered elsewhere for securities of comparable quality. Profit expectations and interest rates are likely to move together since the rise in economic activity resulting from favourable economic prospects brings pressure to bear on financial markets and influences interest rates in an upward direction. An economy in which investment is particularly attractive in relation to other economies, therefore, will tend to have domestic interest rates higher than comparable rates abroad. Of course, the level of interest rates or, more generally, the state of credit conditions, will be influenced by the actions taken by the monetary and debt authorities, but it may be assumed that the authorities will broadly acquiesce in the tightening of credit conditions which occurs in a buoyant economy. Yet this very buoyancy is also likely to lead to a current account deficit. If the Canadian economy is expanding at a rapid rate, especially if it is growing faster than the economies of the United States and other countries and is at or approaching full employment, there will be a tendency for imports of goods and services to rise relative to exports and for a current account deficit to develop to balance the capital inflow, even without exchange rate changes.

The experience of the years 1953-60 tends to support these generalizations. This is a short period and as always there were random occurrences which tended to blur the outline. Nevertheless, it is clear that with the exception of 1960—when there were large capital inflows connected with take-over bids—direct investment tended to be higher during periods of expansion and lower during recessions.[2] Portfolio investment also responded significantly to economic and credit conditions in Canada. Simultaneously, the current account was affected in the opposite direction, with imports rising rapidly during periods of expansion and declining in periods of recession. Three main categories of imports show a strong cyclical movement; machinery and equipment, industrial materials and consumer durables. Fluctuations in the imports of machinery and equipment tended to reflect changes in domestic capital expenditure on these items, which have a high average import content. Imports of industrial materials reflected, with a slightly greater amplitude, corresponding swings in industrial production, while consumer durables imports appeared to be largely determined by cyclical movements in domestic expenditure on durable goods. Thus, over the period, capital account surpluses and

[2] Retained earnings of foreign-owned enterprises in Canada also tend to grow in periods of economic expansion, with higher dividend payout ratios occurring in recession years.

current account deficits tended to be higher during periods of prosperity and lower during periods of recession.

If there were a perfect offsetting of long-term capital flows and the current account balance, one would expect a virtually stable exchange rate over the course of the economic fluctuations experienced in the period. In years of prosperity and restrictive monetary policy in Canada, however, the interaction of heavy capital inflows and the current account deficit produced an appreciation of the Canadian dollar, while in periods of lower levels of activity our dollar tended to weaken. It is natural, therefore, to look to the exchange rate itself for part of the explanation of the balancing process. Indeed, this is precisely what a flexible exchange rate is supposed to do. If there is a tendency for the capital inflow to run ahead of the current account deficit, then pressure on the exchange market will lead to an appreciation of the Canadian dollar. An appreciation of the Canadian dollar will discourage exports and encourage imports of goods and thus increase the current account deficit. The opposite will occur if the capital inflow shows a tendency to fall short of the current account deficit.

We have already referred to this effect in our discussion of credit conditions and expenditure. Our inquiries suggest that the short-term effects of small changes in the exchange rate are likely to be fairly limited. Major changes in the exchange rate which are not quickly reversed are another matter. Canadian experience with such changes is not extensive, the most relevant experience being that resulting from the depreciation of the exchange rate in 1961 and 1962. The effects of this depreciation have been obscured by the imposition and removal of the import surcharges, the reduction in the tourist allowance and other factors which were already at work to improve our international competitive position. Early indications suggest that the effects are significant but that changes in the exchange rate take a considerable time to work their way through the economic system. During the period 1953-60 the exchange rate moved within fairly narrow limits and changes in one direction were reversed before the effects were fully realized. Moreover, changes were often regarded as temporary and therefore as not justifying new production arrangements in Canada. We conclude, therefore, that the limited fluctuations of the flexible rate in the period 1953-60 did not have effects on the current account which were large enough to provide more than part of the explanation of the short-term balancing process. On the other hand, there is little doubt that the average level of the rate did have significant effects on the current account balance in the longer term.

The final possibility is that changes in the exchange rate had effects on the capital account and particularly on short-term capital movements. As we have pointed out elsewhere, small changes in the exchange rate may not have major effects on long-term capital movements. If the interest rate advantage which has been obtained by a Canadian borrower is sufficiently great to offset a change in the exchange rate of 10-15% over the term of the borrowing, short-term fluctuations in the value of the Canadian dollar will be of limited importance. On the other hand, small changes in the exchange rate can have a very considerable effect on the profitability of short-term capital transactions. For example, if under a flexible rate an investor anticipates correctly that the value of the Canadian dollar will decline by 1% in the course of the next thirty days, a purchase and resale of an American dollar asset would yield a normal interest return plus a profit at an annual rate of 12% on the investment. Such speculative flows serve to check the movement of the exchange rate.

As we indicated in Chapter 15, a speculator need not go through these steps, but can instead enter into a forward contract with a bank to buy U.S. dollars. This does not involve a credit-worthy customer in putting up any capital, but allows him to sell the U.S. currency at a profit if the price rise materializes.[3] The transaction will nonetheless have effects on the balance of payments. If the bank cannot find a seller of forward

[3] It may, of course, involve him in a loss if the dollar moves the other way.

U.S. dollars, it will cover its forward commitment by an equivalent purchase of spot U.S. dollars. As explained earlier, this is only an intermediate step; the bank will then seek someone in the market who is prepared to swap spot Canadian dollars and a contract to buy forward Canadian dollars for the bank's offering of spot U.S. dollars and a contract to buy forward U.S. dollars. In short, the bank must find someone who is prepared to hold U.S. dollars for the life of the contract—that is, someone who is prepared to move short-term capital to the United States. If the spot-forward differential is not sufficiently attractive to bring forth investors of this kind, then outright purchasers of forward U.S. dollars will have to be charged a price which will make short-term capital movements to the United States profitable. In either case, the upward movement in the exchange rate will be moderated by the consequences of the speculator's action.[4]

An outright purchase of forward U.S. dollars or forward Sterling is only one of the ways in which participants in the exchange market may react to a developing expectation that the Canadian dollar is likely to depreciate. Exporters receiving payments of U.S. dollars currently or in the future may decide to delay conversion in the spot or forward markets in expectation of receiving a higher price in the future. Similarly, those who have payments to make in the United States may choose to make these payments while the Canadian dollar is at a high level. Borrowers of long-term foreign capital may likewise decide to postpone their issues for the time being or defer bringing the proceeds back to Canada. If, therefore, under the influence of large-scale long-term capital movements the Canadian dollar appreciates for a period, the expectation may develop that the appreciation will be reversed. There will then be a tendency for an outward flow of short-term capital to develop and this will tend to inhibit further appreciation of the Canadian dollar.

[4] The process described is reversed if speculation favours the Canadian dollar.

This is not to suggest that all short-term capital flows in the period tended to moderate swings in the exchange rate. Tightening credit conditions in Canada were often associated with increased flows of unhedged short capital, particularly in the form of trade credit or other inter-corporate indebtedness, which tended to lead to further strengthening of the rate in such circumstances.

Nevertheless, stabilizing speculation of the kind described above appears to have contributed to the moderation of exchange rate movements during the period 1953-60. We found little evidence of what might be called "pure" speculation, that is, speculation which was unconnected with any other trade or capital transactions. We did find, however, that some of those who were participants in the exchange market in the ordinary course of business tended to take a view of the future movement of the exchange rate and act accordingly. It probably puts the point too crudely to say that many of these speculators were characterized by a "parity psychology" but the evidence suggests that when the Canadian dollar went to a significant premium in relation to the U.S. dollar, some participants in the market did not expect this rate to persist.

The explanation of the relative stability of the exchange rate during the period 1953-60 can therefore be summarized in the following terms. There were no depressions during the period in either Canada or the rest of the world. The major shifts which occurred in the Canadian balance of payments derived from favourable economic prospects in Canada which encouraged a flow of capital and at the same time led to a period of economic expansion which encouraged a sharp rise in imports. To a considerable extent, then, there were forces at work promoting a balance without the need for exchange rate changes. The average level of the exchange rate throughout the period exercised a significant influence on the current account, but the temporary fluctuations which occurred around this

level appear to have had a limited short-term effect on trade in goods and services. Changes in the exchange rate did, however, bring forth stabilizing capital movements.

THE FIXED EXCHANGE RATE

While the foreign exchange rate was not formally fixed until May 2, 1962, there were fundamental changes in the flexible rate system a good deal earlier. In the budget of December 20, 1960, the Minister of Finance expressed concern over the impact which the inflow of foreign capital was having on the foreign exchange rate and announced a generalization of the 15% withholding tax on interest and dividend payments to non-residents. This was generally considered to be a measure to restrict the inflow of capital and to reduce the price of the Canadian dollar in the foreign exchange market. It is also worthy of note that in each of the following six months official holdings of gold and foreign exchange showed successive increases; the additions from December 31, 1960 to June 30, 1961, totalled $256 million. In the budget speech of June 20, 1961 the Minister of Finance noted that the Government considered the existing international value of the Canadian dollar (monthly average in May just over U.S. $1.01) to be "unduly high" in the light of general economic conditions in Canada and expressed the following view on the appropriate level of the exchange rate:

> "No one can say today what the appropriate level of our exchange rate would be when our balance of payments is in a position better suited to our present economic circumstances. But the rate will certainly be lower than it has been of late, and it may well be appropriate for it to move to a significant discount. It will be government policy to facilitate such a movement".

In addition to the use of debt policies, this was to be done through direct intervention of the Exchange Fund in the foreign exchange market. The immediate effect of this announcement was a sharp depreciation of the Canadian dollar to just below 97¢ U.S. or a drop of about 3 cents. During the autumn the Canadian dollar showed renewed strength but in November and December it weakened again and from the end of October 1961 to June 22, 1962 the resources of the Exchange Fund were used to resist the decline in the value of the Canadian dollar.

In the early stages of the reserve drain, the authorities made concessions to the speculative pressure by allowing the value of the Canadian dollar to decline. As the loss of reserves accelerated in January and February a further adjustment of the rate was permitted, followed by an attempt to hold the Canadian dollar at around 95¢ U.S.

The behaviour of the rate in late February and March, and the decline in the reserve loss in March, suggest that this measure did lead to some abatement of the speculative pressures. In April, however, pressures were renewed and in addition to losses of $114.6 million from official holdings, the Exchange Fund entered into commitments to sell U.S. dollars forward amounting to $13 million. On May 2nd the Government announced a devaluation to 92.5¢ U.S., formal abandonment of the flexible exchange rate system and adherence to the International Monetary Fund system of maintaining the external value of the Canadian dollar within 1 per cent on either side of the newly established par value of $1.081 Canadian for the United States dollar, with ultimate support points at $1.070 and $1.092.

The devaluation and adoption of a fixed rate was supported by a moderate upward adjustment of the yield on treasury bills. These measures were not sufficient to allay the speculative pressures. During May official holdings declined by a further $102 million and forward sale commitments rose by $72.6 million. The same pattern continued through the first three weeks of June. If we disregard the addition of $650 million of special international financial assistance, official holdings fell by an additional $334.1 million during June and through June 22 additional commitments were made to supply forward U.S. dollars to the extent of $154.4 million.

The measures announced on June 24, 1962, which successfully overcame the crisis, fell into two parts; a domestic "austerity" program and massive international support for the Canadian dollar. Import surcharges and a reduction in the duty-free allowance to returning tourists presented tangible evidence of direct action to reduce the current account deficit. A restriction on government spending, including a civil service wage freeze, gave evidence of direct action to limit the government deficit. A sharp increase in both short and long-term interest rates imposed additional restraint on the domestic economy and served to attract an inflow of capital. This was later supplemented by a long-term government issue of U.S. $250 million sold in the New York market. The international assistance took the form of drawings on the International Monetary Fund equivalent to U.S. $300 million and reciprocal currency swaps with the Federal Reserve System and the Bank of England totalling U.S. $350 million. In addition, a stand-by credit was arranged with the United States Export-Import Bank of U.S. $400 million. In the annual report of the Bank of Canada for 1962, the Governor pointed out that certain central banks in Western Europe had intimated that they were ready, if this were desired, to place additional funds at the disposal of the Bank of Canada. The magnitude of the international support provided and the rapidity with which it was arranged contributed to the restoration of confidence in the Canadian dollar and played an important part in reducing the burden of adjustment on Canada.

The measures initiated on June 24th had a rapid effect on the official reserve position. As pointed out in the budget papers of 1962, on June 24, 1962 the "spot" position of the official reserves had fallen to about $1,100 million and there were in addition substantial forward sales commitments outstanding. At the end of the year, the official holdings, excluding the remaining special international financial assistance of $300 million, had reached $2,239 million. As the reserve position improved through late 1962 and early 1963, most of the steps taken in June were reversed. The import surcharges were removed, and long-term interest rates—which had begun to decline in the late summer of 1962—were in the latter part of the year kept at levels only marginally higher than in the early months of 1962.

The Budget Speech of June 13, 1963 contained a number of tax and other proposals which could be expected to have an effect on the balance of payments. These included a 30% tax on the sale to non-residents of corporations listed on Canadian stock exchanges and a similar tax on the sale of stock in such companies in amounts exceeding $50,000 a day by a single seller. In addition, special incentives were offered to the non-resident shareholders of companies beneficially owned by Canadians to the extent of 25% or more. These shareholders were given a reduction of withholding tax from 15% to 10% while non-resident shareholders in companies with less than 25% Canadian ownership were to have their withholding taxes increased from 15% to 20%. Manufacturing and processing companies with a minimum of 25% Canadian ownership were given the opportunity of writing off new machinery and equipment for tax purposes in two years, while companies with a lesser degree of Canadian ownership were not given this privilege. Subsequently, the 30% "takeover" tax was withdrawn, and the proposed changes in the withholding tax on dividends modified to entitle non-resident shareholders to a 10% rate if at least 25% of the outstanding voting stock was available for purchase by Canadians.[5] In addition, reference was made to proposed tariff changes—since implemented—with the objective of reducing "very greatly" net imports of automobiles and parts.

On July 18th, just over a month after the Budget, the United States Administration proposed an "interest equalization tax" designed to raise the cost to foreigners of borrowing or selling equities in the United States without the necessity of a general increase in long-term

[5] These changes may lead to higher U.S. and other withholding taxes on Canada's growing equity investments abroad, although this will depend on the outcome of negotiations on internationally-agreed tax conventions.

interest rates in the United States.[6] Representations by the Canadian Government led to an exemption for new issues of Canadian securities apparently on the understanding that such issues would not be used to build up Canada's foreign exchange reserves.[7] Canadian official holdings of gold and foreign exchange, which had remained at a high level during the first six months of 1963, fell in July by U.S. $110.9 millions (excluding a repayment of I.M.F. borrowings of $79.7 million) and declined by a further $31 million in August. On August 12 bank rate was increased to 4% from 3½% but the reserves increased again thereafter and interest rates declined.

THE IMPLICATIONS FOR POLICY OF A FIXED EXCHANGE RATE

In thinking about Canadian economic policy for the future it is important to be clear on the way in which the adoption of a fixed exchange rate affects the choice of policies. There are some who feel that the system we had in the 1950's permitted the pursuit of domestic objectives without the need for serious concern over the movements of the exchange rate: they thus expect the fixed rate to lead to a fundamental change in the orientation of economic policy, with international considerations receiving greater emphasis than domestic needs. There are others who feel that our room for manoeuvre under the flexible rate was not significantly greater than it is under a fixed rate and who therefore tend to argue that the two systems are in effect very similar. In fact, the truth of the matter seems to be somewhere in between: under no system is Canada free to ignore international considerations, but under a fixed rate system there is a more immediate and direct link with the international financial environment, a fact which is by no means always a disadvantage to Canada.

It is easy to see how even well-informed people can differ on these issues. There are many apparent paradoxes in the history of the Canadian flexible exchange rate. It was a flexible rate without explicit outer limits on its fluctuations, yet it was very stable after the initial adjustments of 1950-52. In part, this reflected the economic policies followed in Canada. This was also an apparent paradox since a flexible rate is supposed to tempt national financial authorities into policies which are excessively expansionist, but in Canada during 1958-60 restraining credit policies were maintained during a period in which unemployment averaged 6.7%. There was a third apparent paradox in the last phase of the flexible exchange rate experiment. When a decision was taken to use the resources of the government to force down the international value of the Canadian dollar it might have been expected that the government would be a large seller of Canadian dollars. Within a matter of months after this decision, however, the government in fact had to support the Canadian dollar by being a large seller of American dollars—indeed a seller on such a scale that the rate had to be fixed and emergency measures later implemented to maintain it.

Enough has been said earlier to indicate that these paradoxes are more apparent than real. The Canadian exchange rate did not need to be flexible over a wide range in order to perform its functions. Indeed, it is unlikely that a flexible rate which had fluctuated over a wide range would have achieved the degree of international acceptability which was accorded the Canadian rate and is vital to the workability of any exchange rate system. Moreover, wide swings in a fluctuating rate might have been difficult to contain. If the policies followed in Canada had led to the view that there was no reasonable limit to the likely moves in the exchange rate, speculative

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[6] The proposed tax, when enacted into law, is to apply until the end of 1965 and date retroactively to the summer of 1963. It will not apply to foreign direct investment by U.S. residents or to the purchase by them of listed shares in foreign companies in which a majority interest is held in the U.S. and which trade mainly in the U.S. Nor will it apply to bank loans or borrowings of under 3-year terms. On borrowings longer than this, the tax scales up from 2.75% for under 3½-year issues to 15% on issues with a term longer than 28½ years. A number of technical exemptions are also proposed which relate to dealer inventories of foreign bonds resold to foreigners in 90 days, labour union investments, and insurance company foreign investments in connection with policy reserves in foreign countries.

[7] See, p. 14, House Ways and Means Committee Report, No. 1036, December 1963, U.S. Govt. Printing Office.

capital movements might have become violently destabilizing. If, for example, during a period when the United States authorities were imposing monetary and fiscal restraint, Canada had adopted a policy of extreme credit ease and very large government deficits, this might have set off a speculative outflow which would have carried the exchange rate below any level experienced in recent years. This might not have happened on the first occasion. A long record of prudent economic management is not dissipated overnight and a set of policies which diverged from this pattern might well have been regarded as a temporary aberration. If, however, it had become clear from repeated examples that prudence was not to be expected in the future, the reactions might well have become more violent—just as they would under a fixed rate system when the consequences fall on the reserves. The widespread and often vigorous opposition to flexible exchange rates voiced by experts outside this country is based on the disruptive effects of exchange rate changes of this kind. This, however, was not the kind of flexible exchange rate system we had in this country.

Indeed, the charge which reasonably can be brought against the flexible exchange rate is that the international value of the Canadian dollar was too stable in the face of a major change in the economic environment. A substantial premium on the Canadian dollar and large capital inflows were appropriate during the investment boom of 1955-57 but when economic conditions changed it was desirable that economic policy should be so ordered that there would be a fall in the international value of the Canadian dollar, the current account deficit and the capital inflow. Had credit conditions been easier, some of the capital inflow would not have occurred and the value of the Canadian dollar would have been lower: while the consequences would not have been immediate, the lower exchange rate would have stimulated employment, incomes and domestic savings. The policies in fact pursued were thus very different from those which might have been expected to result from the freedom sometimes thought implicit in a flexible exchange rate. Far from begaring her neighbours Canada followed policies which in time led to such dissatisfaction with the level of the rate that an escape was sought through direct intervention in the exchange market.

The consequences of direct intervention were also less paradoxical than appears on the surface. If the government is known to be operating in the market with the express purpose of lowering the value of the Canadian dollar, this is likely to lead to considerable uncertainty among other participants in the market. Once expectations developed that a fall in the value of the Canadian dollar was likely to occur then, in the circumstances of the time, these expectations were very difficult to reverse and in fact were not reversed until emergency measures had been introduced.

The difference between the flexible and fixed rate systems is a matter of degree and not of kind. Under a flexible exchange rate, any country which is a responsible member of the international community and which is concerned with domestic price stability will find that there are implicit, if not explicit, limits to the variation of the exchange rate which is acceptable; movements in the exchange rate which result from policy changes therefore cannot be ignored. Under a fixed rate, attention first focusses on the reserves rather than the rate, but in both cases international limitations on domestic policy are effectively present.

Under a fixed exchange rate, monetary and debt policies have effects on domestic expenditure and on international capital flows, but since the exchange rate is fixed they do not at the same time have an influence over international trade through the channel provided by the exchange rate. The influence of monetary and debt policies on expenditure is correspondingly reduced. This has led to suggestions that under a fixed rate system the primary role of monetary and debt policies should be to influence the balance of payments, leaving to fiscal and other policies the primary responsibility for domestic stabilization. We have already had two examples, in the summers of 1962 and 1963, of increases in interest rates which were inappropriate from the point of view of the domestic economy

but which were regarded as necessary in the light of the international payments position. This suggests that the choice of exchange rate systems may influence the "mix" of policies, although it does not mean that monetary policy must always be geared only to international considerations or that when it is, it is necessarily inappropriate from a purely domestic point of view.

The effects of a given mix of policies will also be different under a fixed-rate system, with fiscal policy having stronger effects. Fiscal deficits and surpluses affect the financing requirements of the government and thus influence credit conditions. Other things equal, fiscal deficits tend to raise interest rates and fiscal surpluses to lower them, and it is the task of the monetary and debt authorities to take these effects into consideration in achieving the credit conditions required in the circumstances. If this kind of accommodating action is not taken under a flexible exchange rate system, fiscal policy changes will encounter dampening effects. Thus the expansionary effects of a federal deficit will be reduced since if the federal deficit increases interest rates will rise, international capital inflows will increase and the resulting upward pressure on the Canadian dollar[8] will lead to adverse effects on our international trade in goods and services. A fiscal surplus, on the other hand, tends to lower interest rates, discourage the inward flows of capital and encourage a depreciation of the Canadian dollar; as a result, the contractionary impact of a Government surplus will be partly offset by effects on the current account of the balance of payments. Under a fixed rate system, effects of this kind influence the level of reserves rather than the exchange rate, and fiscal policy does not encounter offsetting effects working through the exchange rate and the current account of the balance of payments.

[8] There will also be some effects working in the opposite direction. Expansionary fiscal policy increases the demand for imports, thus increasing the demand for foreign currency. Moreover, the existence of a deficit may weaken confidence in the future value of the Canadian dollar with effects on the exchange market.

One would normally expect fiscal and other policies to be pulling in the same direction unless international or other considerations dictated otherwise. However, the example given above is not too far removed from what actually happened in some of the years following 1957, and helps to explain why the relatively large federal deficits in this period, without the support of appropriate monetary and debt policies, did not produce the desired effect on domestic economic conditions. In any event, the reduced effectiveness of monetary policy under a fixed rate system and the enhanced power of fiscal policy under such a system means that the latter must be used more actively to achieve domestic objectives.

While the existence of a fixed exchange rate does have effects on the relative strength of the various instruments of Canadian policy, and can well influence the decisions on the "mix" of policies, it would be wrong to exaggerate the differences. As we have already pointed out, our enquiries indicate that the short-run effects on the flow of goods and services of moderate and temporary fluctuations in the exchange rate are quite limited, i.e. if policy changes are moderate and generally reversed within the period of a short-run cyclical fluctuation, the effects on trade will be relatively small. This in turn means that for policy changes of this kind, the difference between the relative capacity of the various instruments of policy is not greatly different under a fixed than under a flexible exchange rate system.

The issue, however, is not the relative effectiveness of the individual instruments of policy but the general question of the freedom of action of the financial authorities. The central question is not usually whether fiscal ease and monetary tightness is to be preferred to fiscal tightness and monetary ease, but rather whether a policy of general expansion combining fiscal deficits and monetary ease is consistent with the maintenance of a sound external financial position. If the exchange rate is fixed and if changes in exchange and import restrictions are ruled out, the authorities' freedom of action depends on holdings of

official exchange reserves and the acceptable size of changes in them. If the exchange rate is at a level which leads to a continuous addition to the reserves and this is acceptable both domestically and internationally, the authorities will not feel unduly inhibited by balance of payments considerations. Similarly, if reserves are very high the authorities may be prepared to accept considerable losses before permitting balance of payments factors to weigh heavily in the determination of domestic policies.

Normally, the reserves will not be undergoing changes of a disruptive kind, and the authorities should have considerable freedom to pursue domestic economic objectives. If the domestic economy is soundly managed, it should be possible to handle even quite large swings in the reserve position, although such swings are not without their difficulties. If massive additions to reserves occur during a period of buoyancy, it is inappropriate to finance them through the banking system since this will add to the banks' liquidity, bring about an inappropriate easing of credit conditions and intensify inflationary pressure.[9] On the other hand, while an increase in interest rates might be appropriate domestically in such circumstances, it might merely add to the capital inflows. If these flows are expected to be temporary, there are a variety of devices—such as temporary liquid asset agreements with the banks, or sales of non-market securities to them—which can be employed to handle the domestic financing of the reserve changes.

If it becomes evident that the inflow reflects longer-term forces, the authorities will find it necessary to alter the "mix" of economic policies. Larger fiscal surpluses would be needed to provide the necessary domestic financing of reserves and to dampen business activity, since interest rates would have to be maintained at relatively lower levels to avoid adding to the capital inflow.[10] This assumes that the Canadian authorities are able to convince other governments that the reserve accumulations are not harming their international position and to persuade the Canadian public of the need to add to holdings of gold and U.S. dollars with a low rate of return.

Appropriate fiscal policies take on added importance under a fixed rate system, since if they are not used additional pressure will be put on domestic prices. Because price and cost increases are not readily reversible, increases will limit the authorities' ability to combat a subsequent recession because of a weakened international competitive position. Under a flexible rate system these adjustments can come about through upward movements in the rate which are subsequently reversed, although under either system the authorities must be concerned with containing domestic prices and costs to ensure that they do not necessitate continuous and cumulative depreciation of the currency, both internally and externally.

In the different circumstances of major reserve drains in periods of slack activity in Canada, the authorities may need to call on international assistance and bring about some increase in domestic interest rates. If the drain persists and interest rates must be maintained at higher levels than purely domestic considerations would call for, increased reliance must be put on fiscal measures to stimulate the economy and on other policies designed to bring about fundamental improvements in our relative costs of production.

It is sometimes argued that the difficulties with which a fixed rate system may occasionally confront the authorities can be overcome by making it an "adjustable peg" which alters fairly frequently. Both economic logic and the existing international payments arrangements clearly indicate that a change in a fixed rate should be

[9] Such inflows do not present a comparable problem in periods of economic slack because an easing of credit conditions is then appropriate to both the domestic and international situation.

[10] If the present proposal to remove Canada's exemption from the U.S. interest-equalization tax if our reserves become excessive is enacted into law, it might reduce foreign borrowing by Canadians in times of buoyant domestic conditions. It would thus reduce the capital inflows with which the Canadian authorities would normally have to cope when domestic credit conditions are restrictive. This temporary measure, however, is objectionable on other grounds, not least in that it may prevent Canada from accumulating sufficient reserves in such periods to defend the fixed rate in less favourable times.

made if the disequilibrium is fundamental in nature. For example, a rate adjustment would be permissible and necessary if basic demand conditions for exports or imports were to alter in a major way, if the structure of Canadian relative costs and prices were to change substantially or if the character and amount of capital flows were to undergo massive and lasting shifts of a destabilizing nature. However, frequent changes in the fixed value of a major currency such as that of Canada cannot be made without creating serious uncertainties in domestic production, trade and capital flows. If it came to be believed that changes were likely to occur, then at the first hint of difficulties in either direction there would be widespread speculation on the Canadian dollar similar to that which took place in 1962.

If frequent changes in the exchange rate are ruled out, then there will be times when the rate is undervalued relative to existing conditions and other times when it is overvalued. Substantial changes in reserves will often provide the adjustment mechanism in such circumstances, but there is no denying that persistent gains or losses in reserves will limit the extent to which the authorities can follow policies to achieve their domestic objectives. Given the sensitivity of international capital flows, it may be possible to minimize these limitations by gearing monetary and debt policies to international considerations and by placing more reliance on fiscal and other policies to achieve purely domestic aims. Nevertheless, there are limits to this process and it is only realistic to recognize that international considerations will at times in the future, as they have in the past, exercise a decisive influence on the choice of policy at home.

While a flexible rate would appear to have some advantages in Canada's circumstances in that it provides for somewhat greater freedom and effectiveness of domestic monetary policy, its advantages should not be overstressed. The flexible exchange rate was too high after 1957, in part because of domestic credit policies, but there is no certainty that more appropriate measures would have resulted in an exchange rate wholly suited to the structure of our relative costs and prices. If the view had been that the flexible exchange rate had not declined sufficiently, it might have been desirable to fix a lower rate, at least by 1960 when the disequilibrium in our international competitive position was generally evident. This would have made for greater certainty and facilitated the production adjustments in the export and import-competing industries that are necessary if the economy is to come closer to full employment levels.

The authorities cannot escape the consequences of their domestic policy actions on the international financial position under either exchange rate system, although a fixed rate system may bring the consequences of ill-advised steps more quickly and dramatically to public attention. However, when a low value is established under a fixed rate system so that the international consequences of domestic inflation are not immediately felt, poor performance at home will not immediately be reflected in exchange reserves; moreover, a fortuitous change in the current or capital accounts may temporarily mask the international consequences of domestic policy actions. What does remain beyond dispute is that under either exchange system the authorities can mismanage our affairs. Similarly, good economic results can be achieved under either system, although Canada's special position is likely to limit the domestic freedom of the authorities and may necessitate more exchange rate changes in the long run than would be needed by some other industrial countries. In the final analysis, it is not the exchange rate system in use but domestic policy designed to keep the economy efficient and adaptable which is the essential condition of achieving a sound and viable external financial position.

THE EXCHANGE FUND AND SHORT-TERM CAPITAL MOVEMENTS

The role of the Exchange Fund under the flexible exchange rate system was a strictly limited one, but when the decision was taken to intervene in the exchange market in late 1960 the tactics to be followed became a matter of considerable importance. The Exchange Fund oper-

ated extensively in both the spot and forward markets, but in the situation which then existed other steps were required to restore confidence. The question is still open, however, whether under more favourable conditions with more limited speculative pressure, a combination of domestic credit policies and forward operations of the Exchange Fund could be used as a device for overcoming temporary difficulties which otherwise might prove to be too large to be conveniently handled by changes in the official reserves of foreign exchange.

In earlier chapters we have shown how international capital movements respond to interest rate and availability differentials and noted that much of the capital flow has been on an unhedged basis. When, for example, a Canadian issuer sells long-term securities to investors in the United States in American currency, he must assume the risk that the exchange rate over the period up to the maturity of the issue will not change sufficiently to offset the gain in lower interest costs from borrowing abroad. If forward contracts were available so that he could ensure in advance that U.S. dollars five, ten or fifteen years hence could be purchased at a given price, such transactions could be carried out on a hedged basis. Forward contracts of this kind, however, are not normally available and either the borrower—or the lender if the issue is in Canadian currency—must assume an exchange risk. There are also shorter-term capital flows responsive to interest and availability differentials which are frequently not hedged. From the evidence we have examined, and from an analysis of movements in the components of the capital account of the balance of payments, it would appear that an important part of this type of flow can be ascribed to changes in accounts payable and receivable. For example, when credit tightens in Canada, Canadian subsidiaries of foreign firms appear to rely somewhat more heavily on advances from their parent firms through the medium of inter-company accounts while importers generally rely more on foreign trade credit.

Even though some short-term capital movements are unhedged this is not the general rule, since the profit to be gained by the movement of short-term capital in response to interest differentials can easily be converted into a loss by a minor movement in the exchange rate. Such capital movements therefore tend to be made on a covered basis, i.e. they involve a spot purchase and forward sale of the relevant currency. There is clearly a significant difference in the effect on the reserves if short-term capital movements are made on a hedged rather than an unhedged basis. If unhedged movements were the rule, a relative increase in short-term interest rates in Canada would lead to a large inward flow of capital which would persist as long as the relevant interest differentials were kept sufficiently large. If the movements are on a covered basis, however, things are very different. Relatively high short-term interest rates in Canada will attract foreign investors but they will wish to sell Canadian dollars forward to insure against the exchange risk. As a result, the price of forward Canadian dollars will quickly fall to the point where net inward movements are no longer attractive. To the extent that the premium on forward U.S. dollars leads, for example, to an increase in sales of forward foreign currency by exporters and a decrease in purchases of such currency by importers, there will be a current addition to exchange reserves at the expense of additions to reserves in the future.

While the net movement of short-term capital may terminate quickly, there may continue to be large flows in both directions. As pointed out in Chapter 15, covered short-term capital movements in one direction make possible and frequently lead to short-term capital movements in the other direction. If a private purchase of spot and a sale of forward Canadian dollars are matched by offsetting private transactions the other way, there will be no effect on official holdings of gold and U.S. dollars. A corporate treasurer in Canada may find that the rate on "swap" deposits offered by a Canadian chartered bank is attractive and invest surplus funds in a U.S. dollar deposit with the U.S. dollars sold forward. These funds might well be invested in

loans to investment dealers in New York and sold forward. The offsetting spot and forward transaction in the other direction may arise from an American investor buying Canadian finance paper and selling forward the Canadian dollar proceeds at maturity. Clearly, if the Canadian corporate treasurer had invested in the Canadian finance paper directly and the American investor had made a direct loan to an investment dealer in New York, the flows in both directions would have been eliminated. There would have been no difference in the flow of funds between final borrowers and lenders and no transactions in the exchange market. The financial intermediaries have provided services to clients with particular preferences as to the kind of assets they want and the kind of liabilities they wish to assume, and as long as such transactions are offsetting they have no net effect on the reserve position.

If, however, a covered short-term capital movement into Canada occurs in circumstances which lead to an increase in the price of forward U.S. dollars, and this in turn leads to an increase in outright sales of forward U.S. dollars, there will be an addition to the reserves. What in effect happens—through the intermediation of a bank —is that the Exchange Fund obtains the spot U.S. dollars supplied by the foreign investor, and the exporter who has been brought into the market by the favourable forward rate supplies the forward U.S. dollars. Thus current reserves are increased at the expense of future additions to the reserves. Similarly, if the Exchange Fund is prepared to carry out "swaps" by selling forward U.S. dollars directly and purchasing spot U.S. dollars, then again the reserves will increase as a result of a covered short-term capital movement into Canada.

The use of the forward market by the exchange authorities has often been suggested as a major means of preventing a reduction in exchange reserves. For example, if concern over the future value of the Canadian dollar leads to large scale purchases by the public of forward U.S. dollars, the price of the latter will rise. Other things equal, this will make the movements of short-term capital to the United States more profitable and bring pressure to bear on official exchange reserves. If, however, the exchange authorities are prepared to undertake commitments to supply forward U.S. dollars, they can prevent their price from rising and so prevent the movement of short-term capital. If the loss of confidence in the future value of the Canadian dollar is a temporary one, those who have purchased forward U.S. dollars beyond their needs will reverse their transactions and a difficult situation will have been averted.

Some have gone so far as to argue that if the exchange authorities are sufficiently bold in their use of the forward market, the use of this technique alone will be enough to stem a major run on a currency. Their contention is that if the authorities are confident that the disequilibrium is not fundamental and that no change is required in the value of the currency, they can safely undertake virtually unlimited commitments to supply foreign currency. This process can be made painful for the speculator: official operations can be conducted in such a way that, even though he establishes his original forward position at less cost than he could have done without the Fund's intervention, he must pay an even higher price to close out his position. One conclusive limit on the use of this technique is the willingness of speculators to accept without question a commitment to supply foreign currency in the future. Moreover, if the underlying situation calls for a devaluation, the authorities will be involved in substantial losses if they have heavy commitments to deliver forward foreign exchange.

In 1950, when the Exchange Fund bought forward U.S. dollars on a large scale, it could well be argued that there was a fundamental disequilibrium and that such action could therefore not succeed. In 1962, the Exchange Fund undertook to supply forward U.S. dollars to the extent of $239 million. It is difficult to know how large these commitments might have become if the authorities had been willing to continue this policy, although in one week between June 15 and June 22 they increased by no less than $119 million. There is evidence, moveover, that

market participants were concerned over the dangers posed by the possible introduction of exchange controls, and as Exchange Fund commitments became larger and larger these fears might well have been magnified.

This is not to say that official operations in the forward market cannot fulfill a useful function. In our view, there is considerable scope for such operations, either on a unilateral basis or in co-operation with other governments and central banks.[11] Such co-operation is now especially vital in view of the widespread convertibility of currencies and the ease with which international speculative pressures can be triggered off. We would hope that in the development of supplementary defences against such speculative attacks on currencies, Canada will play a useful part. This is particularly important under a fixed rate system since—as already indicated—such a system will occasionally involve major changes, often within brief time periods, in the size of official holdings of foreign exchange.

It is not possible to specify what level of reserves should be held to enable Canada to adjust smoothly and with a maximum of independence to changing domestic and international conditions. Obviously, however, the reserves must be larger than under a flexible system, and the public should learn not to read undue significance into changes which, while large in absolute amount, are not symptomatic of major difficulties. Nor will the desirable level of reserves be an unchanging one: it will depend on such factors as the size and trend of our imports, exports and current account position and on the type and amount of our international indebtedness and capital flows. It will also depend on the speed and completeness with which deficits in our overall balance of payments correct themselves and—very importantly—on the accessibility of temporary international financial assistance.

Similarly, it would be impossible and undesirable to specify any rigid or mechanical rules for official intervention in the spot or forward exchange markets. These must depend on the circumstances of the time, but will certainly involve the authorities in active and continuous market operations under a fixed-rate system. We have heard favourable comments about the decisiveness and skill with which the authorities have operated in the exchange market, and have no reason to propose any changes in the arrangements under which the Bank of Canada manages the Exchange Fund as agent for the Minister of Finance. To return the exchange reserves to the Bank of Canada, where they were located until the war, would serve little purpose, might cause some confusion of responsibility and would involve the central bank in additional open market or other operations to offset the cash reserve effects of changes in exchange holdings.

[11] We believe that official forward commitments should normally be disclosed, but not without a reasonable delay.

OTHER POLICIES TO INFLUENCE THE BALANCE OF PAYMENTS

Our primary concern above has been with the way in which the general instruments of policy influence the balance of payments. Most of our illustrations have been drawn from the period 1953-63, a period during which the current account of the Canadian balance of payments was in continual deficit. There have been sharp differences of view on both the deficit itself and equally on some of the policies which have been proposed for reducing it. Some have held the view almost from the beginning that the deficit was undesirable, that it reflected the unwillingness of Canadians to provide for their own economic development, and that it contributed to the increase in foreign ownership discussed in Chapter 5. Those taking this view were critical of the deficit even in years such as 1955-57 when foreign resources were required to satisfy the demands of the investment boom of that period. When economic slack developed after 1957, they were able to point to the depressing effect of the current account deficit, but the essence of their position was that a sizable deficit was undesirable under any set of economic conditions.

A more balanced view has been put forward by others who have not been greatly concerned about foreign ownership and control and have felt that in periods of rapid growth there is no reason why foreign capital should not be used to supplement domestic savings. In their view, the crucial question concerns the state of economic conditions in Canada. If there is excess demand for output then foreign resources are required. If there is economic slack, no net foreign resources in the physical sense are required; nevertheless, gross flows in both directions may still be needed to realize our full potential, especially since foreign direct investment in new plant and equipment is frequently an addition to total investment rather than a substitute for part of it. The same cannot always be said of takeovers of existing Canadian companies, although there were often benefits in the accompanying flow of technical knowledge, skilled management and established market connections. This body of opinion, therefore, was not critical of the deficit in the years of economic buoyancy and only became concerned when it appeared that some of the capital flow under the flexible exchange rate system was having a depressing effect on the Canadian economy.

There was a similar diversity of views on the steps which should be taken to reduce the deficit in the years after 1957. Some favoured striking directly at the flow of capital or the flow of commodities or both. Many, however, were unprepared to advocate policies which discriminated against foreign investors or foreign trade and argued that much of the excess capital flow after 1957 was a symptom of inappropriate monetary and debt policies.

The direct measures which have been proposed fall into two groups—those designed to affect the current account directly and those aimed at capital transactions. These two types of measures have different effects under a fixed than under a flexible exchange rate. Under a flexible exchange rate system, direct action to restrict the entry of goods and services on current account will tend to lead to an appreciation of the exchange rate. This in turn will reduce exports and increase imports of other goods and services and thus lead to offsetting changes elsewhere in the current account. On the other hand, direct restrictions on capital imports will reduce the demand for Canadian dollars, lead to a depreciation of the exchange rate and set in motion forces which in time will lead to a decline in the current account deficit. In the latter case there could be some offsetting effects within the capital account as a result of the reduction in capital flows tightening domestic credit conditions. In the first case also there may be indirect effects, particularly if resulting higher costs or adverse reaction to the measures at home or abroad impair our economic growth and reduce investment.

Under a fixed exchange rate, in contrast, restrictions on current account transactions will not be offset by exchange rate movements. Similarly, the application of direct restrictions to capital movements will not trip off a mechanism for adjusting the current account through the exchange rate. Instead, the main impact will fall on the official reserves, reducing them if capital imports are limited and raising them if imports of goods are restricted.

Many supporters of direct measures, however, have advocated measures on both sides of the accounts simultaneously. Under a flexible exchange rate, capital account restrictions alone would lead to a depreciation of the international value of the Canadian dollar, but this will not occur if at the same time offsetting direct restrictions on the movement of goods and services are introduced. Under a fixed rate with anything less than high and growing reserves, action taken to discourage capital flows can lead to balance of payments difficulties unless matched by direct restrictions on current account transactions. Alternatively, restriction on current account transactions might so improve the potential reserve position that action would need to be taken to curb the capital flow.

As our earlier discussion makes clear, there has been no lack of examples of direct balance of payments measures affecting Canada in recent

years. However, we have not felt it desirable to analyse these measures in any detailed way, although it is evident that there is almost no limit to the variety of devices which can be and have been used to discourage the flow of commodities and capital. Yet the central question is not how this might be done but whether it should be done. It should be remembered first that all economic policies are interrelated. Thus, for example, the discouragement of non-resident investment which contributes to our economic growth involves paying a price in terms of slower national development, a change in credit policies relative to those in other countries will have inevitable effects on international capital flows, and higher tariffs or other policies which raise Canadian production costs are bound to affect our industry's ability to export.[12]

Second, many international economic policies once established tend to have lasting consequences; it is always dangerous in dealing with a temporary problem to initiate measures the effects of which will be experienced over many years, even when basic conditions have changed. In Canada's circumstances one cannot, for example, sensibly contemplate the imposition of exchange controls to meet short-run peace-time emergencies. Quite apart from the likelihood that their use will be a substitute for the more fundamental measures which would probably be needed in such circumstances, they would have lasting effects on the long-term flow of capital and increase speculative pressures against the Canadian dollar at any sign of the slightest weakness in our external position. Much the same is true of short-run changes in withholding taxes. It is true, nonetheless, that a number of industrial countries have permanently established controls on certain types of capital movements, some of which are now being relaxed, and some also have rules relating to the incorporation or acquisition of domestic companies by non-residents; these rules usually relate to domestic participation in the equity, subject to certain conditions. These, however, are not subject to short-run variation and are not used to discriminate against existing investments. This serves to emphasize that countries adopting such policies must be prepared to accept their consequences on a long-run basis.

A third point to remember in attempting to influence international arrangements is that the nationals of one country are not the only participants in the process. Actions which damage the interests of other countries invite retaliation. The ultimate consequences, both economic and political, of a particular action are therefore always uncertain. Since our international economic actions can lead to serious damage to our own interests they must be carefully considered in the light of their probable impact on our domestic goals of efficiency, employment and price stability.

A fourth consideration which is important in Canada is the division of powers between the federal and provincial governments. Since natural resources are under the control of the provinces, there are both legal and political limits to the extent to which the federal government can expect to exercise an influence over foreign investment.

Finally it must be remembered that in international, as in domestic, financial policy an array of minor measures aimed at subsidiary objectives is no substitute for getting the broad, general posture of policy set in the right direction. If we wish to attain a sound and viable international financial position and not be excessively dependent on foreign capital at times when we have available resources in Canada, the real solution lies in having an efficient, competitive and adaptable economy. Similarly, if we wish to achieve greater Canadian ownership of industry, the solution must lie primarily in increasing Canadian incomes, enhancing the incentives to equity investment and ensuring that our financial institutions and framework do not impede such ownership.

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[12] Many branch plants were set up in Canada to take advantage of the tariff, which thus contributed both to higher non-resident ownership and the competitive inability of some firms to serve export markets.

INTERNATIONAL CO-OPERATION AND THE WORLD PAYMENTS SYSTEM

With an economy particularly oriented towards world trade and closely connected to other capital markets, Canada has a special interest in ensuring that the international financial system works smoothly and that there is a maximum of co-operation between countries to achieve the objectives of high employment, rising productivity and stability of prices. Constructive international arrangements enhance Canada's ability to pursue appropriate domestic policies in the long run by reducing the chances that other countries will pursue inappropriately restrictive trade or credit policies. Moreover, they can greatly reduce the need to undergo excessively painful domestic adjustments to meet short-run international crises; the massive international financial aid received in June of 1962 is a striking example of the usefulness of such arrangements.

Despite the importance of the international payments system for Canada, the subject did not attract much attention in this country during the period of the flexible exchange system. For a decade we had not found it necessary to pay any serious attention to the level of official reserves since adjustments were carried out through exchange rate changes. Moreover, because the reserves changed little, other countries had no direct concern about the effects of our actions on their reserves. Although the Canadian experiment with a flexible exchange rate attracted a good deal of attention abroad, there is little evidence that this experience had much impact on the discussion of possible alternative world payments arrangements. In part this was because our closest associates, the United Kingdom and the United States, are the two reserve countries of the international community, and the Canadian experience was not directly relevant for countries which acted as bankers to the world.

In the last year or two, however, there has been a sharp rise in the attention paid to the international payments system in Canada. The exchange crisis, and the assistance from abroad which helped to combat it, drew attention to the institutions and arrangements designed to deal with such problems. Moreover, the adoption of a fixed rate system meant that changes in Canada's exchange reserves were watched more closely. It is natural therefore that concern for our own reserve position quickly led to an interest in this country in the question of the adequacy of reserves for the system as a whole.

As already indicated, there has been a major change since the days of the gold standard in the economic and political environment within which the international payments system must work. Governments have accepted responsibility for the maintenance of high employment and this implies a willingness to use the general instruments of economic policy to influence expenditure. Unless all major countries are following such policies, the efforts of any one of them to follow expansionary policies can have effects on its balance of payments. Even if all are striving to minimize unemployment, there can be significant differences —for policy, structural, or technological reasons—in the extent to which prices in some countries increase relative to prices in others. Thus, if one country's costs and prices increase more rapidly than those of its trading partners, it will only be a matter of time until its weakened competitive position leads to balance of payments difficulties. In addition, changes in world demand and technology can affect different countries in different ways and may force them to choose between altering their exchange rate or national employment and productivity goals.

The most obvious way of reconciling domestic objectives and international balance is through unilateral decisions to change the international value of the country's currency or the level of exchange controls and other barriers to trade. These techniques were used extensively in the inter-war period, but devaluation on the part of one country usually led quickly to devaluation by other countries; the original depreciation was thus offset, or more than offset, but trade and

capital movements suffered in the meantime from the uncertainties created. In short, it became apparent that one country could only succeed in changing the international value of its currency if other countries did not resort to competitive exchange depreciation. A similar conclusion emerged from the experience with the use of exchange, tariff and other restrictions on trade and capital movements. Any one country acting alone can alter its balance of payments in this way, but if other countries are not prepared to accept the balance of payments consequences, they can offset these effects by imposing similar restrictions. An increase in exchange controls and barriers to trade by all countries may leave the original disequilibrium problem unsolved but will reduce the flow of goods and capital and impose losses on all countries.

The arrangements for the post-war payments system made when the International Monetary Fund (I.M.F.) was established at Bretton Woods in 1944 were a natural response to the inter-war difficulties. Since devaluations, at least by important countries, could not in fact be effective unless other countries were prepared to tolerate them, an agreement was reached on the conditions under which a change in a par value was acceptable. Any proposed change in par value, which together with all previous changes exceeded 10% of the initial par value, required Fund approval. Similarly, restrictions on current payments, other than those used during the post-war transitional period under Article XIV of the I.M.F. Agreement, required the approval of the Fund. Thus two of the most obvious ways of avoiding the restraints imposed by the world economy were made subject to international approval.

Although a number of countries took advantage of Article XIV, on February 15, 1961 all of the major continental European countries and the United Kingdom agreed to accept the obligations of convertibility of their currencies as set forth in Article VIII. Under this Article, they agreed to avoid exchange restrictions, multiple currency practices and discriminatory currency arrangements. If in future any of these countries wish to make use of such measures, they will have to obtain the prior approval of the Fund. Thus, in general, it can be said that any resort to exchange controls by a major country must be accepted internationally if it is not to carry the sanction of denial of access to the resources of the Fund.

While many countries have shown a lingering attachment for exchange restrictions, the same cannot be said for currency depreciation. In part, this may result from special circumstances. The major devaluations of 1949 brought most currencies into a favourable competitive relationship with the U.S. dollar. In recent years, the countries which have faced some continuing difficulties, the United Kingdom and the United States, have been influenced in their thinking by their special position as international bankers. It may be that if the payments position of industrial countries other than the United States worsened, there would be more willingness than in the past for devaluation to be looked upon as a remedy. There has, however, been a considerable reluctance to alter par values—except for a number of less developed countries—and this may well continue into the future.

This places a considerable strain on the international payments system and reserves. If changes in exchange restrictions are virtually ruled out and there is a great reluctance to alter par values, the conflict between domestic objectives and international balance can become very sharp. This conflict lies at the heart of the controversy over international liquidity. Under fixed exchange rates, any divergence from an existing equilibrium can only persist if countries are prepared and able to permit major changes in their international reserves. This, of course, does not mean that countries may keep their economy out of step with their major trading partners; under any arrangements they must sooner or later adjust to the world around them.

Those who think that domestic adjustments should come sooner rather than later feel that international reserves (or access to such reserves)

need only be adequate to tide over temporary situations, i.e. short-run crises in which a limited period is necessary for emergency domestic policies to be introduced and take effect. These people would argue that business, labour and government would in time recognize that international considerations severely restrict their freedom of action and would adjust their attitudes and policies towards prices, wages and other factors affecting the country's international competitive position. Others feel that reserves should be adequate to cope with the large and persistent one-way movements of exchange reserves which may be entailed if countries attempt to deal with a problem of international imbalance by adopting fundamental measures involving a minimum sacrifice of domestic policy objectives.

The extent to which countries should have time and freedom to adjust their domestic policies thus underlies the argument about international liquidity. It is recognized that there can be no ultimate escape from the limitations imposed by membership in the international economy and that international credit, like its domestic counterpart, should be used only for constructive purposes and not to permit irresponsible borrowers to escape the consequences of their actions. Nevertheless, there is an important difference between a system which requires an almost immediate adjustment of domestic policies to international requirements and one which permits greater freedom in the time taken and measures chosen to reconcile the two.

Major developments have occurred in international payment arrangements in recent years and further changes are now under consideration. Indeed, some years hence those with an interest in international finance may describe the current period as one in which fundamental alterations were made to the system. The resources available to the International Monetary Fund have been substantially increased, first by a 50% increase in quotas to a total of about $15.3 billion,[13] and second, by the General Arrangements to Borrow under which ten countries including Canada, the United States, the United Kingdom, Japan and the major continental European countries agreed conditionally to lend to the Fund amounts which total $6 billion. Together with world gold reserves of some $39.2 billion and foreign exchange holdings of $23.3 billion—mainly in the form of U.S. dollars and sterling—these international reserves are equivalent to about 60% of annual world imports of $140 billion. The ratio of reserves to trade is, however, lower than it was in 1953, when it stood at about 80%, and, of course, below that in 1937 when world reserves were equal to 100% of the then much lower value of trade.

There is no simple relationship between the appropriate level of international reserves and world trade. The size of reserves needed depends on their distribution between countries, the severity and length of international imbalances, access to other forms of international assistance, and the willingness of countries to avoid measures which impair world prosperity. Nevertheless, there is a widespread belief that international reserves must be increased if future problems are to be avoided. In particular, there is a danger that the leading countries may pursue inappropriately restrictive trade and credit policies in an unsuccessful attempt to compete with each other for the same limited stock of reserves, and that they will be forced to sacrifice domestic employment and productivity objectives in doing so.

There are many who feel that the I.M.F. or some other broadly-based international institution should be the main channel through which changes in the system are brought about. This

[13] Canada's quota is $550 million (U.S.). Details of drawing rights from the fund are complex (see p. 7, *International Financial Statistics*, Sept. 1963, published by the I.M.F.), but in general a country may more or less automatically borrow up to one quarter of its quota and may borrow up to 100% of its quota subject to conditions about pursuing appropriate policies. It must obtain a waiver from the Fund if it wishes to borrow more than this. The fund is now also prepared to enter into standby agreements; this assures the borrowing country of automatic access to assistance within the agreed limits.

may be the way in which developments finally go, but there are several reasons why much of the initiative is likely to come from other sources. At present the staff of the Fund contains a limited number of international central bankers, while national central banks and treasuries have a good deal of strength in this area. This itself reflects the unwillingness of governments to act to a greater extent through the Fund framework, partly because of the large size and heterogenous nature of the Fund's membership. A high proportion of the routine lending and day-to-day activity of the Fund arises from its relationships with under-developed countries whose problems are very different from those of the industrial countries. There is thus an understandable tendency for the industrial countries to prefer to discuss their problems bilaterally, or in a forum such as the Organization for Economic Cooperation and Development or the Bank for International Settlements where the membership is almost exclusively drawn from countries with similar interests and problems. Thus, many of the recent developments in international financial arrangements have taken place outside the I.M.F., particularly through bilateral arrangements negotiated by the United States.

The widespread international banking responsibilities of the United States provide a favourable setting for such arrangements, which have received added impetus from the payments difficulties which the Americans have encountered. Deficit countries are usually more inventive in developing techniques for meeting payments problems than surplus countries. The United States has been running a substantial current account surplus and is a large creditor on international account, but her long-term investments abroad and her foreign aid programs have involved an increase in her short-term liabilities. Moreover, her gold stock—which reached a peak of over $24.5 billion in 1949—had declined to $15.6 billion at the end of 1963. Losses of gold were regarded as desirable in much of the post-war period since the U.S. had too large a proportion of the world's monetary gold until the latter part of the 1950's. However, U.S. gold holdings have now reached the point at which the Americans have felt it essential to prevent the conversion of short claims from leading to further excessive declines. They have therefore developed techniques for economizing gold and forestalling the conversion of dollar holdings of foreign governments and central banks into gold.

In some cases, this problem has been a temporary one and has been met by the use of currency "swaps". If a foreign central bank acquires dollars on a temporary basis which it ordinarily would convert into gold, the Federal Reserve System initiates a drawing against a previously arranged credit with that bank and buys the dollars for the period of the swap. The process can be reversed at the end of the period and a temporary gold movement avoided, the transaction in effect having provided an exchange guarantee to the foreign central bank and thereby having dissuaded it from making a gold purchase. If the additions to dollar holdings of foreign governments or central banks are not expected to be temporary, another technique is used. The United States Treasury sells special bonds denominated in the currency of various European countries—including Italy, Germany, Switzerland, Belgium, and Austria—to foreign central banks and treasuries, and uses the proceeds to purchase holdings of dollars. This again provides an exchange guarantee to foreign governments and central banks on part of their dollar holdings[14]

These swaps have also been used, together with credits obtained by the U.S. Treasury, for extensive operations in forward and spot exchange markets when temporary, but strong, destabilizing speculation has occurred; these transactions are subsequently liquidated when

[14] Total swap lines with 10 central banks and the Bank for International Settlements amounted to $1,550 million at the end of August 1963, while U.S. Treasury foreign currency bonds outstanding at the same date amounted to the equivalent of $705 million U.S.; five central banks and one government were involved. The actual net debtor position of the Federal Reserve under the swap lines was $73 million in early September.

conditions become more favourable, or are funded into foreign currency bond issues. For example, operations in forward German marks reached a peak outstanding of some $340 million U.S. equivalent in June 1961; similarly, a total swing of some $175 million in the Belgian payments position in the year ending October 1963 was financed through the swap facility and Treasury issues with that country, thus economizing on the use of gold reserves.[15] In effect, additional international reserves are created by these techniques, which the authorities can use to prevent runs on existing reserves. In addition, countries in need of temporary extra reserves have drawn on these swap facilities or on *ad hoc* credits from the world's central banks—for example, Canada in 1962 and the United Kingdom to the extent of $900 million in early 1961. Finally co-operative operations by central banks have been undertaken in the London gold market to prevent speculative disturbances from leading to currency flights.

These are now temporary expedients, but if the "temporary" period is long enough, and if the facilities are put on a regular basis and the amounts involved are large enough, a considerable step has been taken to provide time for more fundamental adjustments to take place. The announced willingness of the United States to acquire foreign currencies might well involve large amounts over an extended period. If this were to occur during years in which the United States payments position was again strong, countries which have acquired reserves of U.S. dollars and gold in recent years will not have to draw down their holdings; instead, their currencies will be used to add to the reserves being accumulated by the United States against future eventualities.

The recent experience has been a useful one and has contributed to a realistic appraisal of the problem and of the possible solutions to it by governments, central banks and international institutions. At the same time, the various proposals which have been made for major reforms of the international financial system have attracted a good deal of attention and alerted legislatures and financial communities to the need for serious thinking about these issues. At the 1963 meeting of the International Monetary Fund, it was decided that two studies should be made of the problem of international liquidity, one by the I.M.F. and the other by representatives of the ten countries which had participated in the General Arrangements to Borrow.

It is our view that it is in the interests of this country that, with appropriate safeguards against irresponsible borrowing, international reserves should be gradually increased so that time will be available to national financial authorities to make adjustments to their international positions while at the same time retaining some freedom of action to pursue domestic objectives of policy.

One possible answer to this problem, but one which we do not support, would be an increase in the price of gold. This would require action by the United States, and Canadian governments in the past have wisely refrained from making pronouncements on this subject. A writing-up of the gold price would naturally benefit Canada as a gold-producing country—particularly in a period when we had unemployed labour—and would make a contribution to increasing international liquidity. However, except for relatively minor effects on the annual production of gold it would be a once-over, large and abrupt change which would not deal with the problem in a continuing way. (We rule out small changes since they would merely trigger speculation on further changes). Quite apart from the inequity of the relief it would provide (the main beneficiaries would be gold-producing countries and those which held large gold reserves, while those which had played a constructive part in improving international liquidity by minimizing gold holdings would be penalized), the solution lacks the elements of discretion and gradualness which are essential if a lasting answer to the international liquidity

[15] For a full discussion, see the excellent and informative articles in the *Monthly Review of the Federal Reserve Bank of New York*, October 1962, March 1963, and October 1963.

problem is to be found.[16] As with the domestic financial system, which we no longer leave to the uncertainties of gold production, the answer to the international financial system's problems lies in the intelligent management of an expanded stock of credit rather than in adjusting the price of gold.

Wherever the ultimate solution to the world's future liquidity needs is found, however, it is worth noting that Canada found its own answer to this problem in the 1950's through the use of a flexible exchange rate which moved within narrow limits. This may be a solution which has some application for other non-reserve countries since to the extent that it is used the need of such countries for additional reserves would be strictly limited and pressure on the existing stock of international liquidity correspondingly reduced. The solution more likely to emerge, however, is a system in which countries are able to avoid conflicts between the domestic and international objectives of policy through access to additional international reserves. In any event, there is no doubt that recent thinking and market experience will lead to constructive proposals which will contribute to the further development of the international payments system.

We would like to stress in conclusion that the soundest of international payments arrangements, while essential if the world economy is to perform satisfactorily, is no guarantee that national objectives will in fact be achieved. Much depends upon how wisely individual countries, particularly the major trading nations, manage their affairs. Yet the higher the degree of co-operation among national governments and the greater their willingness to co-ordinate their efforts to achieve sustainable economic progress and high employment, the more likely we are to establish the sound international environment necessary to accomplish our aims.

[16] Any inflationary potential stemming from the monetary consequences of a rise in the gold price could presumably be neutralized by the world's central banks, although such an increase might induce some countries to adopt unsound policies.

CONCLUSION

In our view the existing parity of 92½¢ U.S. is a good exchange rate for Canada and one which we hope can be maintained for a long time to come. Whether or not changes in the exchange value of the currency will be necessary in the more distant future will depend upon future developments, including changes which may be made in the world payments system. Under any financial arrangements, however, the Canadian economy will be subject to pressures arising from world trade and investment trends which will limit our independence of action. Our financial policies, particularly our monetary and debt policies, should never be carried out without regard to their international consequences and a fixed exchange rate will help to ensure that this is the case. Operation of the present system will involve substantial swings in our international reserves, and from time to time will require active foreign exchange market operations to counter speculative pressures. At the same time, it will mean that monetary and debt policies designed to achieve domestic objectives will have to be reasonably consistent with our short-run international economic position.

The best way for us to maintain a sound external financial position will still be to have a soundly-managed economy at home. While we indicated in Chapter 5 that the burden of our external indebtedness is not excessive, we have pointed out that inappropriate financial policies can lead to the attraction of more foreign capital than is necessary or desirable in periods of slack in the economy. No doubt there will continue to be gross flows of capital in both directions and net drawings on foreign resources to supplement Canadian savings in boom periods, but we do not believe that the country needs to be heavily dependent on foreign financing at all times, especially when there are unused resources available in Canada. As in other aspects of policy, we are more likely to be successful in this aim if we take fundamental measures designed to improve the competitiveness and adaptability of

the economy than if we deal only with the symptoms of the problem. In this task, constructive international co-operation to achieve high employment and price stability can play an important role, and Canada should take an active part in bringing about needed improvements to world payments and other facilities designed to achieve these goals.

CHAPTER 24

FISCAL POLICY

In our study of monetary policy, debt management and exchange rate policy we have been unable to avoid paying considerable attention to fiscal policy, i.e. the tax and expenditure policies of the government. This has been the case in both a narrow and a broad sense. In the narrow sense, tax and expenditure policies affect the cash requirements of the government and these in turn influence the actions of the monetary and debt authorities. In a broader sense, the fiscal policy of the government does a great deal to shape the economic environment within which the other policies must operate. In this chapter we shall be concerned with the contribution the tax and expenditure policies of the government can make to the achievement of the objectives of policy.

It is clear from our earlier analysis that a good deal turns upon the ability of the government to make effective use of fiscal policy. If the future is like the past, the domestic and international forces influencing the Canadian economy will at times lead to a satisfactory level of aggregate demand combined with reasonable price stability, and at other times either to excessive inflationary pressures and marked price increases or to an inadequate level of demand and excessive unemployment. If these conditions are anticipated, policy changes are required to reduce as far as possible either an excess or deficiency of demand. We have concluded that if the excess or deficiency of demand is of a major kind, even a judicious use of monetary, debt and exchange rate policies alone will almost certainly not achieve the desired results in a reasonable time. We must, therefore, accept the fact that a good deal of reliance must be placed from time to time on fiscal and other policies if Canada is not to fall far short of achievement of her policy goals.

Our enquiries have confirmed that changes in credit conditions brought about by monetary and debt policies in recent years have influenced expenditure, but they have also convinced us that the effects to be expected in offsetting short-term fluctuations are strictly limited. Over periods extending beyond the short-term business cycle, the effects can well be larger. Given enough time, it may be possible to vary credit conditions over a wider range, and in particular to bring about significant changes in long-term interest rates. In addition, over a period of several years all of the direct and indirect effects of changes in credit conditions will have time to work through the system. However, in the absence of accompanying exchange rate changes the longer-term effects of monetary and debt policies on the demand for goods and services will be weaker than at some times in our recent history.

We have considered the possibility that the relative weakness of monetary and debt policies used within the conventional range could be overcome by operating these policies over a wider range. But general changes in credit conditions in Canada relative to those in other countries influence capital movements across our borders. This in turn affects the exchange rate or the exchange reserves or both, but under a fixed

exchange rate system the primary effect will be on the exchange reserves. For both domestic and international reasons there will be some limit to the extent to which these reserves are permitted to fluctuate and thus some limit on the range over which credit conditions can be allowed to vary. It may be possible through the use of selective credit controls to widen the range of variation of credit conditions with a dampened effect on international capital movements which affect our exchange reserves, but in our opinion these weapons are too blunt and arbitrary in their effects to use except under emergency conditions. We can see even more objections to the general use of other direct controls. We are thus driven to the position that there will be times when vigorous use of the fiscal instrument will be essential to an effective stabilization policy, although it will not necessarily assure success.

The notion that governments should use their tax and expenditure policies to reduce fluctuations in the private sector of the economy is not a new one. Indeed, these ideas are at least fifty years old, and in some forms much older, but they had not become widely accepted prior to the great depression in the 1930's. Thus when national governments were faced with a catastrophic decline in employment and output at that time, many of them reacted initially by reductions rather than increases in expenditure. The principal reason for this reaction was the deepset public belief in the desirability of a balanced budget, a belief which is perhaps best described as a rule of thumb which men have developed over the years to prevent their representatives from being unduly extravagant. If political leaders are required to undertake the unpleasant task of levying additional taxes in order to carry out the relatively popular act of increasing expenditure, they will tend to exercise restraint in reaching decisions on spending. Moreover, under conditions of full employment, if government expenditure is increased without additional taxes being raised, there will be an excess demand for goods and services and prices will rise. As a safeguard against both extravagance and inflation the public have tended to apply a simple test to a budget: is it balanced or unbalanced and by how much? This may be a reasonable and sensible test if applied over a series of years, but if interpreted to mean that governments must balance their budgets in each and every year it is inconsistent with the broader obligation of governments to use their tax and expenditure policies to stabilize and balance the economy.

The fundamental idea of using fiscal policy as an instrument for mitigating economic fluctuations is a straightforward one. When the level of demand forthcoming from the private sector of the economy is too low to make for prosperous business conditions and high employment, it makes sense to suggest that governments supplement this demand by carrying out the construction of needed public works. Conversely, in periods when the level of private demand is too high and pressure on available resources leads to rising prices, governments can ease the strain on labour and other physical resources by refraining, as far as possible, from undertaking spending projects of their own. Proposals of this kind were in fact made prior to World War I. But such arrangements have implications for the rule of the balanced budget. Most of the stimulating effect of additional government expenditure on public works during a period of economic slack would be lost if new or increased taxes were imposed to raise the revenue to finance the construction. On the one hand, increased government spending would be adding to the stream of spending and incomes in the economy, but on the other hand higher taxes would produce an offsetting reduction in the incomes of individuals and businesses and tend to reduce their expenditure. Thus increased reliance must be put on borrowing as opposed to taxing, i.e. government deficits must be incurred during periods of economic slack. Conversely, in periods of excessive demand, it would be undesirable to reduce taxes merely because government expenditure is being reduced. Such action would limit the restraining effect of a reduction in government expenditure by adding a compensating amount to the incomes and hence expenditure of those in the private sector of the economy. The conclusion follows

that during periods of excess demand the government should plan to collect revenue in excess of its spending, i.e. run budgetary surpluses.

Thus even if the stabilizing fiscal policy of the government is restricted to an attempt to schedule public works in a way which provides opportunities for employment during periods of slack and reduces pressure on resources during periods of excessive buoyancy, this calls for deficits in some years and surpluses in others. It is only one further step to recognize that similar stabilizing effects can be achieved by changes in the level of taxation in place of, or in addition to, changes in government expenditure on goods and services. If the level of effective demand is too low, a reduction in taxes unaccompanied by a reduction in government expenditures will add to the incomes of individuals and businesses and thus produce a net increase in spending and employment in the private sector. If the government encounters considerable difficulty in increasing its expenditure on public investment during a period of economic slack, or if the change likely to be brought about is too small in relation to the short-fall in demand, a reduction in taxes provides a further source of stimulus. Alternatively, an increase in taxes adds to the effect realized in a period of excess demand by a curtailment of public investment. A combination of changes in taxes and expenditure of this kind can lead to substantial deficits and surpluses in particular years but if the policy changes are appropriately timed and the amounts involved are not excessive in relation to the fluctuations in economic activity, then such policies can make a substantial contribution to the achievement of the objectives of economic policy.

The view that this wider approach to fiscal policy is necessary in Canada was officially recognized almost twenty years ago in the White Paper on Employment and Income in which the government adopted a "high and stable level of employment and income . . ." as a major aim of government policy. It was recognized that such an aim could only be achieved if, among other things, the government were prepared to run surpluses or deficits as the economic situation required, with a balance only being achieved over a period of more than a year.

> "The Government will be prepared, in periods when unemployment threatens, to incur the deficits and increases in the national debt resulting from its employment and income policy, whether that policy in the circumstances is best applied through increased expenditures or reduced taxation. In periods of buoyant employment and income, budget plans will call for surpluses. The Government's policy will be to keep the national debt within manageable proportions and maintain a proper balance in its budget over a period longer than a single year".

While there has been a limited acceptance of this view, succeeding post-war governments have been inclined to apologize for their surpluses or deficits even in years when a failure to bring down an unbalanced budget would have amounted to a dereliction of duty. As a result, public understanding and support for an effective fiscal policy has not been readily forthcoming, and this in turn has come to be regarded as a limitation by governments. This is a vicious circle which has been partially broken once and needs to be broken again. It must be clearly recognized that one of the principal functions of the Government of Canada is to order its tax and expenditure policies so as to contribute to high employment, stable prices, economic efficiency and a sound external position. At times this will call for a surplus of revenue over expenditure, at other times for a balanced position and on still other occasions for an excess of expenditure over revenue. Fiscal policies designed to limit the wastes of unemployment and idle capacity or to prevent the damages and inequities of inflation can be entirely consistent with a strict regard for efficiency and economy in government and entirely consistent with a wide range of views on the appropriate size of government. Nor need they be a serious bar to the development of a well-balanced structure of taxes, even though it would be an advantage if tax and expenditure policies could be decided upon without regard for the needs of economic stabilization. In short, an effective fiscal

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policy is quite compatible with a government which is moderate in size, efficient in the use to which it puts the public's resources, and sensible in the way it raises its revenues.

An effective fiscal policy is also quite consistent with a level and rate of growth of the public debt which past experience has clearly demonstrated is manageable. A rough indicator of the national burden of servicing the federal debt is provided by the ratio of interest payments on the debt to national income. In 1962, despite a series of deficits since 1958 and a level of interest rates well above the historical average, the ratio of interest payments to national income was only around 2.6%. This compares with 2.7% in 1929, 3.1% in 1939, 3.6% in 1949 and 2.2% in 1957. As indicated in Chapter 4, debt charges are also a much lower percentage of federal revenues than they were in the late 1920's or the depressed 1930's. While the effect of increases in the federal debt should be carefully assessed, it is clear that large increases can occur over the long run in a growing economy; in this respect the federal debt is not unlike private indebtedness. The relative burden in terms of national production may even fall in such circumstances.

There is in fact a good deal of misunderstanding of the problems posed by the public debt. In particular, exaggerated fears are often expressed over the consequences which will flow from a series of deficits which lead to an increase in the debt. While we do not think that an increase in the federal debt is unimportant, it should be realized that private debt usually rises slowly in periods of economic slack, and that all forms of indebtedness in the economy may not be increasing rapidly. Moreover, unemployed labour and unutilized plant and equipment produce nothing. If these resources can be put to use through a reduction in taxes or an increase in government expenditure, this is a gain to the economy as a whole. As chart 24-1 shows, the ratio of federal debt to national production hardly changed from 1957 to 1962 despite cumulative deficits amounting to about $3 billion on a public accounts basis. If these deficits had not been incurred, G.N.P. and federal revenues would undoubtedly have been lower, and the ratio of government debt to output and revenues might not have been much reduced.

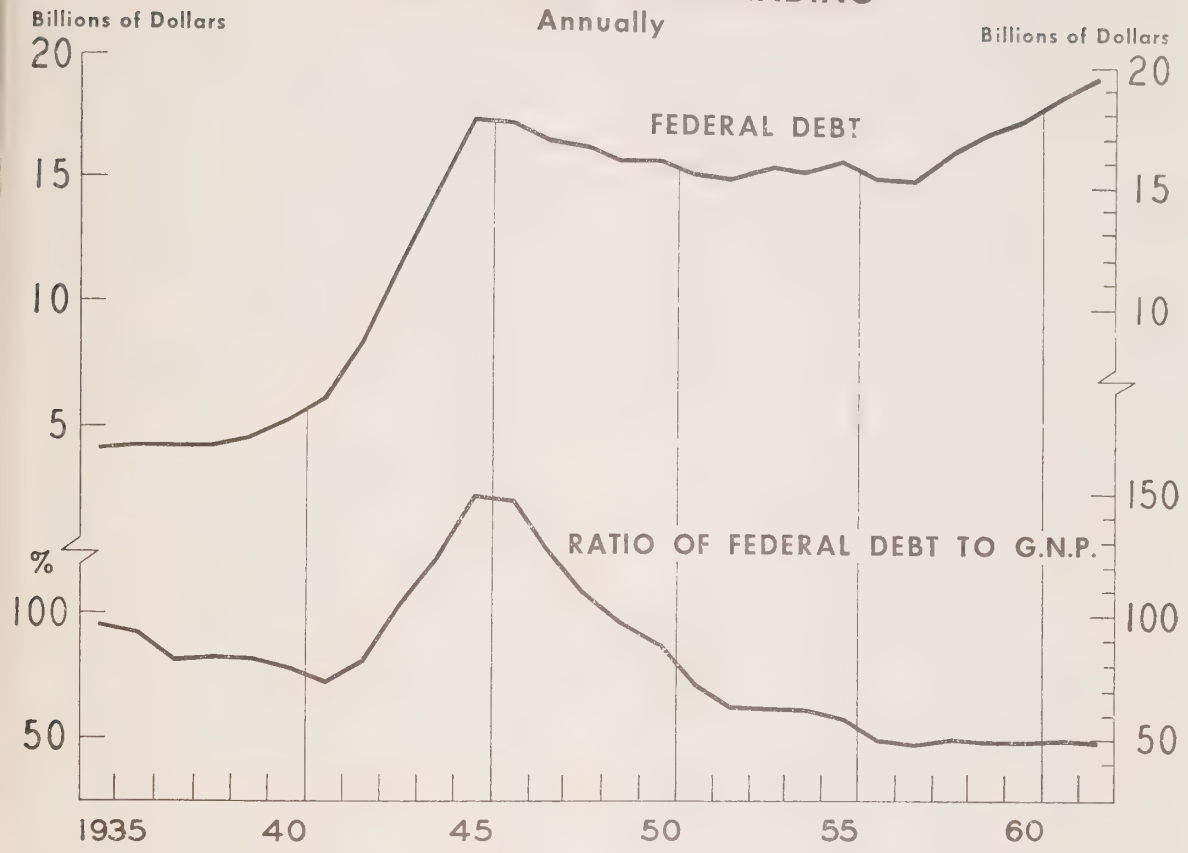
We can specify no rules as to what size of deficits or surpluses are appropriate in varying circumstances. This will depend on the severity of the economic downturn or boom, the method by which deficits or surpluses are incurred, the purposes for which government expenditures are made, and their influence on national production. Nor is there any formula for relating the amount of government debt to G.N.P. to guard against inflationary pressures. As the chart shows, this ratio was about 80% before the war and yet conditions were still depressed and prices weak. On the other hand, we have had inflationary pressures with much lower ratios and sizable government surpluses. Clearly, everything depends on the prevailing economic environment.

Government deficits, in addition to having direct effects on incomes and expenditures, will also have indirect influences. The private sector's holdings of financial assets in the form of government bonds will increase and this may exercise a stimulating effect on expenditures and incomes.[1] On the other hand, a larger deficit—or smaller surplus—will tend to tighten credit conditions and thus have some indirect contractionary effects on economic activity if not accompanied by accommodating monetary and debt management policies. It is argued that increases in the community's wealth and liquidity resulting from such expansionary fiscal and monetary policies may pose problems in a subsequent period of excess demand. This, however, need not be true if a combination of fiscal surpluses and restrictive credit policies is employed in such periods.

This is not to say that the task of adjusting fiscal policy is easy. On the contrary, it is very difficult and the necessary skills will be acquired only with persistent effort. Unless governments can reach reasonably accurate judgments as to

[1] The increased government debt is not usually regarded as a liability by the tax-payers who will have to service it. To the extent that it is so regarded, the stimulating effect of the deficit will be reduced.

Chart 24-1
FEDERAL DEBT OUTSTANDING
Annually



what the economic situation will be, there is a danger that action will be taken too late. This likelihood is enhanced if changes in fiscal policy are generally carried out only once a year. Given the time it takes for fiscal changes to be introduced and to have effects on output, this requires governments to agree on the economic conditions and problems that will have to be met for well over a year ahead. This is not the only problem. As we shall argue in greater detail below, the amount of expenditure which is both under the direct control of the federal government and capable of substantial variation over the short-run is fairly limited. This means that a good deal of reliance must be placed on the concerting of policies among the three levels of government and that tax rates must become more flexible than they have been in the past. Both of these steps raise major political and administrative problems.

Nevertheless, it is important to find ways to overcome these difficulties. This is particularly true under a fixed exchange rate since it further enhances the power of the fiscal instrument to influence expenditure relative to that of the monetary and debt instruments. However, under any exchange system the fiscal instrument can operate powerfully and directly on the flow of income. In addition, changes in fiscal policy which are well within the bounds of the practical can be used to provide incentives to, or impose disincentives on, private spending which are simi-

lar to those brought about through changes in monetary and debt policies. As pointed out later in this chapter, taxes or subsidies on investment—and other fiscal measures—have been introduced by other countries with effects far greater than anything likely to be experienced from changes in interest rates alone. We believe, therefore, that developments in fiscal policy—if effectively co-ordinated with other policies—hold out greater hope for improvement in the economic policy performance of the government than corresponding developments in monetary and debt policies. These are not, however, alternatives: the greatest hope for improvement lies in the co-ordination of all economic policies and their direction towards the desired goal. Yet, despite its powerful effects, fiscal policy has not been vigorously or extensively used in the post-war period, and excessive reliance has at times been placed on monetary policy.

While we have felt that our analysis would be incomplete without consideration being given to fiscal policy, we are not prepared to make precise recommendations in this field. To do so would lead us into some intricate tax problems which we leave with some enthusiasm in the competent hands of the Royal Commission on Taxation. There are, however, four aspects of fiscal policy on which we comment:

1. the budget surplus or deficit—public accounts, national accounts and cash requirements;
2. the built-in stabilizers;
3. discretionary tax and expenditure changes;
4. the possibilities of concerting policies with the provincial and municipal authorities.

THE BUDGET SURPLUS OR DEFICIT

There is more than one meaning which can be attributed to the terms surplus and deficit, and in Chapter 4 we have discussed some of these differences. In thinking about fiscal policy, we are particularly interested in those items of government expenditure and revenue which directly influence income levels. Additions to the level of income include purchases of newly produced goods and services and transfers to persons and business enterprises. The subtractions from the income stream include taxes, payments into Unemployment Insurance, Old Age Security and government pension funds, and miscellaneous government income. Purchases and sales of existing assets do not have a direct effect on economic activity. For example, if the government acquires a piece of land or an existing building, this does not increase employment and income directly in the way in which the hiring of a new employee does. The indirect effects of the purchase of an existing asset may nevertheless be significant as the proceeds of the sale to the government are put to use elsewhere.

One of the deficiencies of the public accounts budget presented by the Minister of Finance to Parliament is that it includes some transactions in existing assets. It also includes some transactions among government accounts which are of a strictly bookkeeping nature and excludes a number of government activities of an income-influencing nature[2]. The public accounts surpluses and deficits in a particular year are therefore an inadequate measure of the contribution the government is making to the income stream. A more accurate indicator of the effect of fiscal policy on the economy is provided by the national accounts. These accounts are designed to measure the flow of income, and the estimates of the government sector which they contain are specifically devoted to this end.[3]

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[2] Payments into and out of the Old Age Security Fund and the Unemployment Insurance Fund are not included in the public accounts budget, although costs of administering the Unemployment Insurance Fund and any deficit incurred by the Old Age Security Fund are included.

[3] See the discussion in Chapter 4. It will be noted that the national accounts budget measures corporate tax accruals rather than government receipts from the corporation income tax, a contrast to the public accounts which record transactions at the time cash actually changes hands. It is true that the corporations have the use of the accrued but unpaid corporation income taxes, but if a change occurs in the level of the tax this can be expected to have an effect on decisions at the time the tax liability is incurred rather than at the time the tax is remitted to the government. Measures were taken in the 1963 budget to reduce the time which elapses between the accrual of corporate tax liabilities and payments to the government.

The national accounts budget nevertheless excludes a number of financial transactions which are of interest in any total assessment of the effect of government fiscal actions on the economy. For example, loans to and investments in the Central Mortgage and Housing Corporation, the Farm Credit Corporation, the Canadian National Railways and other government enterprises are excluded from the national accounts, although they are included in the accounts used to estimate the cash requirements of the government. The cash requirements estimate also includes loans to foreign governments and advances to the Exchange Fund. It thus provides a measure of the government's need to run down its cash balances or sell debt to non-government holders.[4]

Changes in these cash requirements have an important effect on credit conditions. For example, in a year of buoyant economic activity the government may decide to increase taxes and reduce expenditure and convert a national accounts deficit into a surplus. Other things equal, this will reduce the government's cash needs or increase its cash surplus or convert a net demand for funds into a net supply of funds, as was the case in the early post-war years. If, as has typically been true in the past, these funds are used to reduce debt, credit conditions will be easier than they would have been in the absence of the government surplus and the resulting retirement of debt. It has been suggested to us that under these circumstances the government should add to its cash balances. As we mentioned earlier, there may be occasions when the monetary and debt authorities decide that this is a useful means of varying the components of credit conditions. However, they may normally find that the retirement of debt and offsetting action through other monetary and debt operations is preferable. The crucial point being made by those who oppose the retirement of debt during a period of prosperity is that if excessive demand pressure exists, credit conditions should be established which will contribute to the achievement of the domestic and international objectives of economic policy. In some post-war years, this was not the case, and the effect of the fiscal surpluses of those years was diminished by the failure to tighten credit conditions in the face of excessive pressure on the economy.

Thus, when surpluses and deficits are being discussed, there are three numbers to which reference can be made—the figure derived from the public accounts, the estimate made in the national accounts and the cash requirements of the government.[5] There can be significant differences in the results shown by the three measures. For example, in fiscal 1951, the public accounts showed a federal surplus of $211 million and the national accounts a surplus of $873 million while there was a cash surplus of $107 million: in fiscal 1962, the three figures showed deficits of $791 million, $551 million and $478 million respectively. It would be useful if, as in some other countries, estimates were provided of the projected national accounts surplus or deficit at the time that the public accounts budget is presented. However, no system of budgeting can fully reflect the impact of government on the economy. For example, changes in the terms and conditions of lending by government agencies such as CMHC represent changes in important components of credit conditions, although not formally classified either as fiscal or monetary and debt policies. The blurred nature of the distinction between the various instruments of policy serves to emphasize the importance of co-ordinating them all closely.

[4] It would be helpful for analysis of the government's position if statistics on the federal government's cash position were available at least quarterly in seasonally adjusted form.

[5] Suggestions have also been made that a budgetary statement should be developed which draws a distinction between current and capital items to help draw attention to the fact that in some respects governments are like corporations in that at least some of their debt has as a counterpart the real capital assets they have acquired. Although the line between a current and a capital item is frequently a fuzzy one and some new uncertainties can result, the separation of capital and current accounts is a common practice among a number of other national governments and Canadian provinces. The provinces, however, have a different system of accounting than the federal government and most of them include debt retirement as a current expense.

BUILT-IN STABILIZERS

If governments design their budgets to secure a long-run balance or to give a balance at a high level of employment, there will be surpluses and deficits as output expands and contracts. These surpluses and deficits occur without any discretionary changes in expenditures or rates of taxation. A fall in output and employment will lead to a fall in revenue automatically. In the case of some taxes, revenue will fall more or less in proportion to the decline in economic activity, for example, when a decline in domestic output and sales affects the yield of the general sales tax, excise taxes and excise duties. A fall in employment will also reduce payments into the Unemployment Insurance Fund. Some items in the tax base are particularly sensitive to changes in economic activity, including corporate profits, imports and manufacturing shipments. This is especially true of corporate profits, and the accrued yield from the corporation income tax thus varies very sharply with economic activity. In addition, the rate of personal income tax is higher on higher incomes, and changes in personal income therefore have a magnified effect on the yield of the personal tax.

In the absence of a discretionary reduction, most expenditure items will not decline in response to a fall in output and employment. For example, most normal departmental expenditures, defence spending and welfare payments such as family allowances and old age pensions will be maintained. On the other hand, some expenditure items, notably payments from the Unemployment Insurance Fund, rise substantially during periods of economic slack and thus contribute in a major way to a national accounts deficit. The term "built-in stabilizer" has been used to refer to all revenue and expenditure items which automatically contribute to surpluses in periods of buoyancy or deficits in periods of slack. These built-in stabilizers, especially on the revenue side, are much more important than they were a generation ago because of the increased government reliance on corporate and personal income taxes noted in Chapter 4.

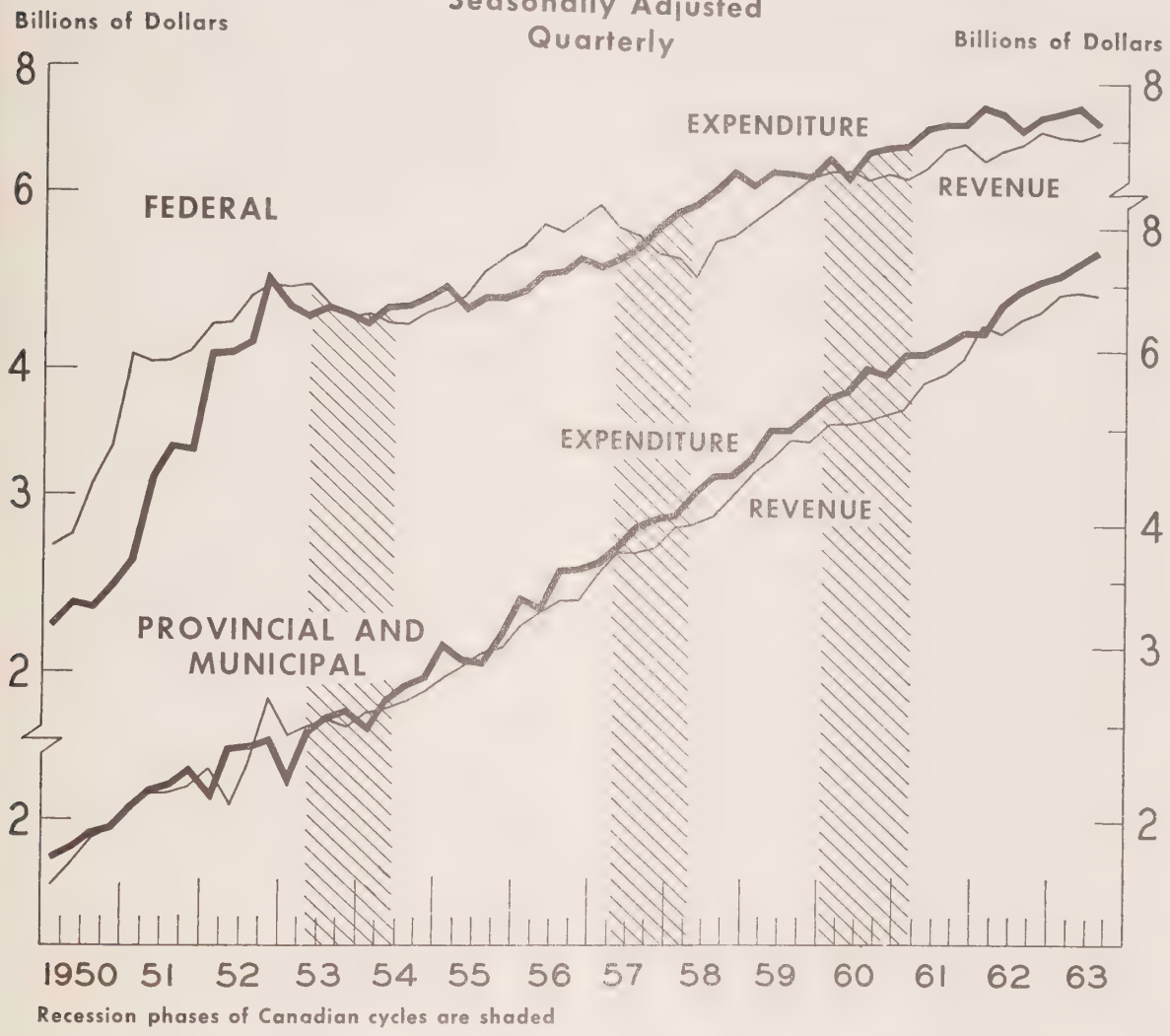
Chart 24-2 indicates the extent to which the revenues of the federal government have fluctuated over the course of the last three business cycles. To some extent these fluctuations represent discretionary tax changes, in particular the tax cut of 1957, but in large measure they reflect the contribution of the built-in stabilizers. For comparative purposes, trends in provincial and municipal revenues and expenditures have also been shown. It is evident from the chart that little in the way of contra-cyclical changes in revenue and expenditure have occurred at the provincial and municipal level, although the lack of pro-cyclical fluctuations has contributed to the stability of the economy. It will also be noted that there is little or no apparent cyclical change in federal expenditures in aggregate.

The built-in stabilizers have some advantages over discretionary tax and expenditure changes. They are brought into action automatically without delay. As soon as unemployment rises and incomes are reduced, the fiscal system begins to provide some resistance to further movements in the same direction. This is true both for a rise and for a decline in economic activity and thus the economy gains a measure of inherent stability which it would otherwise lack. It needs to be emphasized, however, that the built-in stabilizers are passive rather than active instruments of policy. They resist cumulative movements in one direction but they do not actively promote corrective action in the other direction. They can contribute to preventing a recession becoming a depression or to moderating a runaway boom, but they do not actively promote prosperity or restrain inflation. Indeed, if measures taken to encourage or discourage economic activity are proving successful, the built-in stabilizers come into play on the other side. This diminishes the quantitative impact of a given change in discretionary policy and must be taken into account

Chart 24-2

GOVERNMENT REVENUES AND EXPENDITURES

Seasonally Adjusted
Quarterly



Recession phases of Canadian cycles are shaded

when such policy changes are being considered. For example, a fairly sizable cut in tax rates may be necessary to stimulate economic activity, although the actual outcome may be a comparatively small deficit if it is successful. This is because higher personal incomes and corporate profits will increase tax revenues and higher employment will increase unemployment insurance contributions and reduce benefits.

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DISCRETIONARY CHANGES IN TAX AND EXPENDITURE POLICIES

The built-in stabilizers are the result of past decisions, but work automatically without the need for current decisions. Discretionary policy changes, on the other hand, require a positive decision in the light of existing and anticipated economic conditions; on occasion this is a serious

handicap. It has frequently been the case that few or no changes have been made in taxes or expenditure in the face of considerable fluctuations in income, or that the changes have come so late that they have contributed to excessive movements in the other direction.

Economic stabilization considerations are only one of the many influences shaping government decisions on taxes and expenditure. On occasion there is a happy conjuncture of circumstances in which other than economic factors are responsible for fiscal decisions, but these decisions nevertheless turn out to be timely from the point of view of stabilization. On other occasions, economic stabilization considerations are less well served by the decisions which emerge from the many competing influences which help to shape government budgets. This comment could equally well be made of many other government policies, economic and non-economic. It is only mentioned here to indicate that even if a solution could be found to some of the difficult technical problems of fiscal policy, success or failure will still turn upon the willingness and ability of governments to give due weight to the achievement of the objectives of economic policy.

If discretionary changes in taxes or expenditure are to contribute to economic stability, the major impact on output must come before a change in economic conditions dictates discretionary changes in the other direction. This is not difficult if one is dealing with extended periods of economic slack or over-expansion. In such circumstances, delay in recognizing the need for action and delay in taking action will mean that for a period the performance of the economy is inadequate. However, once steps have been taken there is ample time for the effects to work through the system with no danger that the direction is wrong. The danger is much greater in dealing with short-term fluctuations. If there is a significant delay in recognizing the need for policy changes and there is a further delay in taking action, a danger exists that by the time the major share of the influence on output and employment is felt, economic conditions will have altered. Under these circumstances the effect of frequent policy changes can be perverse, with fluctuations being made larger rather than smaller than they would have been in the absence of discretionary changes.

We have already discussed the problem in some detail when considering discretionary changes in the other instruments of policy. The factors leading to delays in the implementation of fiscal changes and the lags in the subsequent effects on output and employment are somewhat different than in the case of the other instruments of policy and vary depending upon the nature of the fiscal change. However, because of the budgetary process, the time taken to put a given fiscal policy into action is normally longer than for monetary and debt policies. This is particularly true if large changes are contemplated; such changes will, of course, be necessary if the excess or deficiency of demand is pronounced. Moreover, because of the stability of consumption, the dampening effect from the automatic stabilizers in the federal revenue structure, and "leakages" of Canadian expenditure into imports, the "multiplier" effect of fiscal changes may be smaller than once thought. This is a matter which is receiving study from others, but obviously fiscal changes have to be larger the smaller is the multiplier; for example, if the multiplier were five, a fiscal change of only $30 million would be needed to bring about a $150 million increase or decrease in national spending, whereas if it were as low as 1.5—which some believe to be the case in certain circumstances—a fiscal change of $100 million would be needed to get the same effect.

There are many ways in which the government can affect the level of demand through its tax and expenditure policies, but it is convenient to think of them as falling into two categories, direct and indirect. Direct measures include changes in the government's own demand for goods and services arising, for example, from decisions to accelerate or postpone public works. Indirect measures include all the steps which can be taken to influence expenditures in other sectors of the economy. The most important indirect measures open to the government are tax changes, but indirect measures also include changes in

transfer payments such as family allowances and old age pensions. Similarly, transfers from the federal government to the other levels of government can be regarded as indirect measures.

(i) *Tax Changes*

Indirect measures such as tax changes take time to have effects on output and employment. The length of this period is of some importance in indicating whether it is worthwhile taking steps to reduce the period it takes for the tax changes themselves to occur. If the "outside lag", that is the lag between the changes in tax rates and the consequent effects on output and employment is very long, there may be little hope of an effective use of fiscal policy for combatting short-run fluctuations. Efforts to shorten the "inside lag", that is the lag between the time when action should be taken and the time when in fact it is taken, would then have a lower priority.

We have had some preliminary econometric studies made on the extent and timing of the response of consumer expenditure to changes in personal income tax. These studies were not extensive, but the general results are of interest. One of these studies indicated that if personal disposable income—that is, after-tax income—were increased by $100 million in a given quarter and maintained at this new higher level, it would take 3 to 6 months for consumption to increase by around $50 million and 12 to 15 months for consumption to increase by around $75 million. The stimulating effect of these estimated increases would be reduced to the extent to which they spilled over into imports, and increased by the further expenditures which they would induce.[6]

This statistical result is derived from the average of recent Canadian experience of the relationship between income and consumption, and no difference was detected in the response of consumption to changes in personal disposable income arising from tax changes as compared with other changes. The change in consumption expenditure resulting from a particular tax change, however, might well depend upon a number of factors, including the direction of the change, the groups affected and the circumstances of the period. We would not, therefore, be prepared to place too much weight on these estimates in predicting the response to a particular tax change. We do, however, regard these results as providing some positive evidence that the likely lag in the response of consumer expenditure to income tax changes is not by itself long enough to preclude the use of tax changes as a means of mitigating short-term cyclical swings.

Turning to business capital expenditures, similar calculations show a relationship between construction expenditures on the one hand and retained earnings and depreciation allowances on the other. A similar relation between internally generated funds and expenditure on machinery and equipment did not emerge from the statistical analysis. Since it is not easy to explain this difference between expenditures on construction and expenditure on machinery and equipment, we have some doubts about the usefulness of these estimates. They do indicate, however, that if corporate retained earnings and depreciation allowances rise by $100 million and remain at the new level, 9 to 12 months would elapse before business construction rose by as much as $35 million.[7]

Our survey of corporations indicates that there are some firms which work fairly closely to the level of their internally generated funds in determining their capital expenditures, while others are influenced to varying degrees; it might have been expected, therefore, that at least some relationship would have appeared in the statistical series. In general, however, the pressure of demand against capacity, and its accompanying strong profit prospects are more important in determining the level of investment than the availability of internal funds. As in the case of the results for consumption, the relationship which emerges from the statistical study is the average

[6] See the excerpt from the paper by R. M. Will—*Post-War Fiscal Policy in Canada: A Study of Policy and Policy Lags,* to be published by the Canadian Tax Foundation.

[7] *Lags in the Effects of Monetary Policy in Canada,* Chapter XI, prepared for us by H. G. Johnson and J. W. L. Winder.

response to any change in internally generated funds, and the response to a particular tax change might well diverge from this average, particularly if it signalled a general tax climate more favourable to business enterprise. Nevertheless, the results indicate that a tax cut to stimulate investment has smaller, slower and more uncertain effects than one designed to stimulate consumption.

Changes in business disposable income may be made by varying corporate or other tax rates, or—for businesses with substantial durable assets—by varying the allowable rate of capital cost allowance. Assuming a given stream of gross earnings, an increase in the allowable rates of depreciation increases the rate of return on new investment as well as cash flows and therefore has effects essentially similar to lowering the rate of interest payable on borrowings to finance the project. We in Canada have had some experience in varying the allowable rate of depreciation, but have by no means exhausted its possibilities. On the other hand, too many variations may create uncertainties or simply cause businessmen to ignore their effects.

Various calculations can be made to show the effect of changes in the allowable rate of capital cost allowances. These all depend on a series of assumptions about tax rates, the absence of much over-capacity, the profitability of the firms concerned and the method of calculating capital cost allowances. The estimated effects are therefore indicative rather than precise. For example, Mr. E. M. Bernstein, who appeared before us, submitted some calculations to the Joint Economic Committee of the United States Congress in 1962 on the effect of a number of tax and interest rate changes on the gross annual investment costs of equipment. He showed that a change which accelerated capital cost allowances from 20 years to 10 years had effects on the gross annual investment costs of a piece of equipment similar to a reduction in the rate paid on borrowed funds from 5% to 4%. An acceleration of depreciation from 20 years to 5 years has effects approaching those resulting from a change in interest rates from 5% to 3%. Similar calculations can be made showing the effect on the after-tax rate of return on a discounted cash flow basis.

It can be shown, for example, on the basis of a particular set of assumptions,[8] that a change in the capital cost allowance on a Category 8 asset from 20% per annum to 40% per annum can raise the after-tax rate of return by 1½% from 6.4% to 7.9%. If the entire cost of the asset could be written off in the year of its acquisition as a current expense, then assuming there were income available against which to apply the tax credit, the prospective rate of return would rise from 6.4% to 9%. Similarly, if the law permitted a corporation to take this asset with an eight-year life and a 20% per annum capital cost allowance into the pool of depreciable assets at 125% of cost, the prospective after-tax rate of return would rise from 6.4% to 8.3%. It can be shown that the effects of such changes on the prospective rates of return are higher for short-lived assets than for long-lived assets. These changes are large when compared with the after-tax effects of changes in interest rates on borrowed funds. A change from 6% to 4% in the interest rate on borrowed funds on an after-tax basis is roughly equivalent to a fall of 1%. Comparable dampening effects on capital investment can be obtained by decreasing the rates or deferring the application of capital cost allowances as was done in Canada during the Korean War period.

We were particularly interested in the description given to us by Professor E. Lundberg of the methods used by the Swedish government to exercise an influence over the amount, timing and character of private capital investment expenditure in Sweden. Companies in Sweden are encouraged to set aside annually a portion of their profits in an investment fund. Profits transferred to this fund are not taxed, provided the fund is managed in a manner consistent with

[8] Assume an investment of $200,000 in a machine lasting 8 years with no scrap value and that working capital of $60,000 is required to operate the machine. Operating profits from the machine over the eight successive years of its life are expected to be (in thousands of dollars), 70, 65, 60, 40, 50, 30, 30, 20. With a tax rate on profits after depreciation of 47%, the prospective rate of return on this investment discounting the future cash flow to the present is 6.4%.

the economic policy of the government as evidenced in the regulations from time to time. Capital expenditures out of these funds are authorized as business conditions warrant. Since no taxes have been paid on the funds, such authorized capital expenditures are in effect fully written-off immediately; on one occasion an additional "investment deduction" of 10% of the funds so used was allowed as an expense for the purpose of calculating taxable income.[9] Many variations upon this particular scheme may of course be devised. According to Professor Lundberg, this method has been applied with success in Sweden since 1957. Its success is attributed in part to the fact that it is based on voluntary participation by firms and in part to the fact that the changes in the advantages of undertaking capital expenditures, though drastic, are recognized as temporary. Accordingly they have induced rapid response. As in the case of other schemes which provide very favourable conditions for investment, there is a possibility that too much capacity will be put in place, although this appears unlikely if profits are basically unsatisfactory.

Another Swedish device illustrates the way in which the fiscal instrument can be used to alter the conditions influencing investment decisions to an extent which would not be possible through the use of conventional monetary and debt policies. In 1955, in response to a situation of excess demand, the Swedish government introduced an investment tax of 12%, brought about a 1% increase in interest rates and established credit rationing. As Professor Lundberg points out:

> "An investment tax of 12 percent is, in comparison with the normal interest rate changes of 1 to 2 percent, enormous. These investment charges were, with certain exceptions, to be levied on expenditures for machinery and building investments effected during the year. If—and this has often seemed to be the case—companies expected these charges to be removed after one or two years, there was good reason for them to postpone their investments if possible and thus avoid an extra capital cost. Over one year it can be said that, with respect to the investment expenditure concerned, the companies had an extra interest cost of 12 percent and that the short-term interest rate may thus have amounted to more than 15 percent".[10]

Fortunately, an investigation was made of the effects of the combination of measures taken by Sweden in 1955. Questionnaire enquiries were carried out in 1955 and 1956 involving 2,200 and 1,100 companies respectively, the companies being asked how much bigger their investment expenditures would have been in the absence of the measures taken. It was concluded that manufacturing industry's investment expenditure on machinery, building and plant had "been cut down below the planned level by close on 15%". As pointed out by Professor Lundberg, this appeared consistent with the totals shown for the whole economy:

> "The policy pursued during the 1955-57 boom aimed at checking investments was actually so effective that, despite high profits and rapid expansion, the volume of industrial investments remained practically constant at the 1954 level. Instead—and this is clearly a successful feature of the stabilization policy followed in Sweden during the period in question—these investment outlays (calculated in constant prices) rose very steeply during the recession years of 1958 and 1959 (by 11 and 9 percent, respectively); the investment tax was abolished at the beginning of 1958, this being followed by a reduction in the interest rate at the same time as the restrictive credit policy was brought to an end".

He concludes that the "ordinary interest rate increase of 1 per cent must appear to be of minimal importance in the explanation of the policy effects". Professor Lundberg told us that

[9] Transcript, p. 4339. See also *State of the Economy and Policies for Full Employment*, August 1962, Hearings of the Joint Economic Committee of the U.S. Congress, p. 716, for details.

[10] Skandinaviska Banken, No. 4, 1962. See also Transcript, pages 4335-6.

this view is supported by the results of the answers to the survey questions on the relative importance of the various measures which showed that half of the effect in damping down investment resulted from this tax, with most of the balance coming from credit-rationing policies.[11]

While tax measures of this kind have the great advantage of being effective, their very effectiveness opens the door to considerable inequities. Firms which are fortunate enough to have just completed a substantial investment program or firms which are in a position to postpone future expansion easily are clearly little affected. Other firms which badly need additional capacity might have no choice but to proceed in spite of the additional costs arising from the tax. The purpose of the tax, however, is to discourage investment in a particular period, and in this respect it imposes the same burden on all firms regardless of any differential advantages they might have in other areas. Clearly, such measures should be used only in extreme circumstances if they are to retain their effectiveness—a point to which Professor Lundberg alluded. We have no enthusiasm for frequent and extensive tax changes of this kind with all their potentially disrupting effects.

When use is made of any fiscal measures, particularly those with as powerful an effect as these, it is clearly of great importance that the timing should be correct. This is made difficult if it is common practice to restrict fiscal changes to an annual budget. Parliament has the fundamental right to control the collection and disbursement of funds but there are opportunities for varying the application of revenue laws other than at the time of the annual budget, and for most of them there are precedents. For urgent circumstances, it is possible to call Parliament into a special session, while under more ordinary conditions there can always be an additional or supplementary budget. Moreover, while tax rates and tax liabilities are set by Parliament, the rates of deduction at the source are administratively controlled. If circumstances justified it, it would be quite possible for a government to announce that it would bring in legislation when Parliament assembled to reduce or increase income tax liabilities by 5 or 10% and adjust the deduction requirements immediately. A similar change could be made with capital cost allowances or excise taxes, although the former do not involve deductions at the source. Such abnormal action, however, we think would be desirable only in exceptional conditions.

[11] Transcript, page 4275. He went on to note that in 1960-61 the credit measures were not so drastic, the time lags were long and the effects hardly visible. However, he noted that no interviews were carried out at that time and that too little is known about the period.

(ii) *Changes in Expenditure on Goods and Services*

If taxes are reduced or transfer payments increased, consumers and business firms will subsequently be induced to expand their consumption or investment. When added spending on goods and services is undertaken by the government, there is no intermediate step in the spending process. However, a serious limitation on federal contra-cyclical expenditure policy is the small total of the expenditures which as a practical matter can be varied in response to changing business conditions. Out of total budgetary expenditures in 1960-61 of $6 billion, only about $415 million—on a national accounts basis—was capable of substantial year to year variation. This was expenditure on capital projects and amounted to 5.1% of the total public and private spending on capital formation. It is apparent that, in order to achieve a swing of $100 million, defence and non-defence capital spending would have to change by about one-quarter.

There are also practical difficulties in accelerating or decelerating a capital expenditure program. The major difficulties in expanding and speeding up government capital projects are the time consuming processes of determining requirements, site selection, planning, getting Treasury Board approval and, finally, of obtaining parliamentary authorization. There is the added difficulty of determining when measures to promote expansion or contraction are required and what interval is available for the preliminary work. We therefore emphasize again what we have said

elsewhere about the importance of speeding up the availability of statistical indicators and the co-ordinating and strengthening of economic forecasting throughout the government departments.

We have been gratified to note that a longer-term perspective on capital expenditures is developing within the government service in Ottawa. The Public Works Department for example, likes to keep projects covering a span of about three years under continual review so as to be able to accelerate its program should the need arise. The Department of National Defence makes provision for continuing review and development of projects proposed by the three services. Defence projects are classified according to priority, the Treasury Board's approval for those of highest priority is sought and a general indication of Treasury Board's likely future decision on those of lower priority is also obtained. The objective is to have a pipeline of projects at various stages of preparation and completion so as to ensure an early start on projects included in any year's estimates and to permit acceleration of the program should that be necessary. In 1962, the Department of Finance began the practice of asking departments, at the time of forwarding estimates for the forthcoming year to the Treasury Board, also to submit forecasts of expected expenditure requirements for three years ahead. Departments have been advised that it is hoped to extend this to a five-year projection as soon as practicable.

All these developments we welcome as adding to the flexibility of the capital expenditure program. If the shelf of public works can be made the pipeline of public works, we may expect more support from capital expenditures for the general stabilisation program of the government. Forward planning of capital projects over a period of three to five years does not imply in our minds a five-year budget or spending program to be submitted to Parliament for approval. It is necessary, however, for the government to look far ahead, to include in the estimates for each year provision for development expenditures covering projects in the early stages of the pipeline, and to come forward with supplementary estimates if it is desired to accelerate expenditures.

Even if forward planning provides a stream of projects ready for execution, it is not easy to bring about an increased flow of expenditure with a minimum of delay. It takes time to receive bids, award contracts and complete all the formalities. There is a further delay between the time that all the terms of the contract are settled and the beginning of construction. Our staff obtained some evidence on this lag from Defence Construction Ltd. On a typical group of projects involving small buildings, they found the delay between contract awards and the start of construction was a month and a half in the winter and under a month in the summer. There is also a lag between the time that construction begins and the time when on-site employment reaches a substantial level. This lag tends to increase with the size of the project and to be longer for projects which are started in the winter. Considerable efforts should continue to be made to minimize the delay between the time a decision is taken to increase government expenditure and the time that the benefit is felt on the level of economic activity.

PROVINCIAL AND MUNICIPAL EXPENDITURE

Such variation in federal government expenditure as can be achieved will have helpful but not adequate effects. To achieve substantial results there must be some co-ordination of federal with provincial and municipal expenditures. We noted in Chapter 4 that spending on goods and services by provincial and municipal governments is now over one and a half times similar federal spending, while their combined capital outlays are three times those of the central government. We do not suggest or imply here any encroachment by the federal government on the responsibilities of other governments. Indeed, we believe that progress in the concerting of policies can only come about through agreements about the objectives and limits of co-ordination.

It is nevertheless clear from the evidence presented in earlier chapters that the existing methods, which depend to a considerable extent on the sensitivity of provincial and municipal expenditure to changes in credit conditions, are relatively ineffective. In recent years, when credit conditions have altered significantly, the capital expenditures of provinces and municipalities have not been influenced enough to give us any confidence that monetary and debt policies provide an effective means of adjusting the capital expenditure programs of the provinces and municipalities to the needs of economic stabilization. What is required is a more direct and more effective method of co-ordination.

We have found in our enquiries sufficient interest in such co-ordination among provincial governments to lead us to believe that significant progress can be made, though persistence and patience will be required. The more the federal government can restrict its interest to the timing and amount of the capital expenditures of other governments and the less it seeks to influence their direction, the more effective the co-ordination will be. As we noted in Chapter 4, there are considerable delays involved in spending on detailed joint-cost programs, and their usefulness is further limited in some instances by the slowness with which the federal government makes payment for work already completed.

We have not explored these matters sufficiently to justify us in suggesting machinery for the exchange of information and views and for reaching an understanding on the methods and limits of co-operation. However, the responsibilities of the continuing Committee of Ministers of Finance and Provincial Treasurers and their officials might be extended to cover the question of co-ordination. While we do not have precise proposals to make, we are satisfied that any successful arrangement will involve making it cheaper and easier to finance provincial and municipal works in periods of slack employment and more expensive to undertake them in periods of economic boom. It will be necessary also that these governments can depend on such arrangements for the future.

CONCLUSION

Our general position is that the limited effects of monetary and debt policies alone require that more use be made of fiscal policy as part of a co-ordinated economic policy than has been the case in the past. Of course, the fiscal instrument has limitations. As in the case of all other policies, there are difficulties encountered in foreseeing future developments and acting with sufficient speed. If action is taken too late, it can add seriously to future difficulties. Moreover, at any point of time there are limits to the vigour with which fiscal policy can be used. These limits derive in part from the difficulty and undesirability of making massive and frequent changes in expenditures and taxation—particularly in taxes on business—in part from international payments considerations and in part from the effect of fiscal changes on domestic and international confidence.

Many of these limitations, which are by no means rigid or sharply-defined, can be overcome by a wise use of fiscal policy. For example, in times of modest or short-lived economic contractions, temporary cuts in taxes and a moderate speeding-up of useful public works at all levels of government are less likely to have adverse effects on confidence than are deficits created solely by a program involving continuing higher expenditures. Similarly, obvious make-work spending on projects of doubtful utility may easily impair confidence in the government's policies. Moreover, higher continuing expenditures will necessitate higher taxes subsequently, and may lead to the inhibition of enterprise and investment and thus slow our economic growth. If such outlays also lead to continuing deficits even in buoyant periods, they may absorb undesirable amounts of national savings, increase our reliance on foreign capital and lead to the suppression of desirable business investment.

In cases of more prolonged or serious economic difficulties, changes in tax and expenditure policies can and should be more pronounced. However, even though these new revenue and spending levels are expected to be necessary for several

years, the measures taken should be designed in ways which do not impair the ability of the government to deal with a new set of circumstances. In other words, they should be carefully planned, should be capable of reversal, and—on the expenditure side—should play a constructive part in the longer-term development of the economy.

Regardless of the circumstances in which fiscal policy may be needed, it is important that the government plan its measures deliberately. Haphazard measures are always disturbing, especially if they are unco-ordinated with other aspects of policy. Similarly, a series of minor measures or fiscal steps which have more eye-appeal than effects are no substitute for a broad and well-thought-out general policy which is clearly aimed at stabilizing the economy. Appropriate fiscal deficits or surpluses incurred in sensible ways for sensible purposes are, after all, not national disasters—they are acts of prudent economic management.

Indeed, we think that there may be circumstances when deficits or surpluses may need to be considerably larger than they have been in the past. This should not prove unmanageable if the government has a reasonable and acceptable pattern of policy—including a clear and consistent view of its financing plans. The Minister of Finance must be willing to explain, rather than apologize for, deficits and surpluses. If the government's program is clearly and vigorously explained to the public and if the measures it contains are both constructive and reversible, there is good reason to hope that the contribution of fiscal policy will be greater in the future than it has been in the past.

We have already offered our comments on ways in which the tax system might be made more flexible. While changes in government expenditure on goods and services are difficult to make quickly on a sufficiently large scale, the development of an adequate pipeline of projects will make possible a more rapid reaction of expenditure to changing economic conditions. In addition, greater co-ordination among the three levels of government can add significantly to the size of the changes brought about. Nevertheless, difficulties in developing an effective fiscal policy will remain, and we recognize that costs will be associated with overcoming these difficulties. But we have no doubt that unless the fiscal instrument is made a more effective part of general economic policy, we shall from time to time have to bear the much heavier costs associated with avoidable unemployment or inflation.

CHAPTER 25

CHOOSING AND CO-ORDINATING ECONOMIC AND FINANCIAL POLICIES

Like any other activity in which man must apply imperfect judgment and limited knowledge to a changeable and unpredictable environment, economic policy-making is an uncertain art. In it, scientific principles must co-exist uneasily with feel and flair, mechanical formulae lead at least as frequently to disastrous error as to reliable results, and ideal solutions lie impenetrable behind realities which often allow choices to be made only in terms of the lesser of two evils. Yet if no reasonable man can expect perfection of policy, the world is not so difficult—nor the instruments available to the authorities so few and ineffective—that an intelligent approach to economic problems must be either doomed to failure or totally dependent for success on the working of the fates. On the contrary, it is one of the main theses of our report that properly conceived and co-ordinated policies can significantly improve the performance of the Canadian economy. While an impeccable record will never be achieved and luck will always play some role in the outcome of events, a not inconsiderable part of Canada's economic destinies will be determined by the wisdom with which financial policy is chosen and executed.

Economic and financial policy will, however, make a useful contribution to the attainment of the objectives of rising productivity, high and stable levels of employment, price stability and a sound international economic position only if a number of conditions are fulfilled. First and most important, the authorities must get the broad "set" and timing of general policy right; for example, when stimulation of the economy is required, numerous minor steps—some of them aimed primarily at subsidiary goals—are unlikely to meet with measurable success if the general tenor of fiscal and monetary policy is inappropriately restrictive. Secondly, if a suitable policy climate is to be created effectively, monetary, debt, fiscal and international economic policies—as well as other non-financial measures—must be co-ordinated into a coherent whole. These individual strands of policy are not so independent in their effects that they can be considered as separate and isolated responsibilities of different arms of the government. Nor is any of the instruments so powerful when unsupported by the others that they can be regarded as alternatives to each other in the sense that a craven choice in one area of policy can conveniently be left to be offset by a bold step in another.

Thirdly, a successful and unified approach to policy must be based on the application of balanced and informed judgment to widely varying circumstances. It is tempting to seek an ideal prescription of policy which could be easily or automatically applied to a simple set of readily recognizable situations. In practice, however, the correct and feasible combination of policies can only be devised in the light of what is suitable to the unique set of circumstances emerging at the time. Fourthly, and following from all that we have just said, the quality of policies will be dependent upon the quality of our political

leadership and of public opinion generally. Finally, success in this difficult task will be achieved only if the officials who advise on policy are skilled and vigorous, equipped with prompt and relevant economic information, and able to assess events against a longer-run background as well as against the immediacy of today.

We cannot emphasize enough that the essential condition of successful policy is to get the general instruments set in the right direction for the prevailing circumstances. If the broad aggregates of demand for goods and services are not encouraged to move towards the appropriate level in this way, the performance of the economy is likely to be unsatisfactory. Moreover, if suitable steps to stimulate or restrain total output are not taken, there will be a strong temptation to introduce a series of direct measures which attack the symptoms rather than the disease and have little effect on demand levels, prices and employment in the nation as a whole. Indeed, such measures may lead to complications and confusion, to increased government intervention in the economy, to high-cost production in particular areas or industries and to discriminatory barriers to the flow of resources; their net effect may thus be to impede the achievement of national objectives.

The recent discontent in Canada with the general instruments of policy, and the increasing resort to more specific measures, is not a necessary result of the difficulties of using broad monetary and fiscal weapons effectively. As we have seen, the process has stemmed at least as much from an unwillingness to use these instruments in the way necessary to achieve national goals. The examples given in earlier chapters need not all be repeated here, although it is worth illustrating the point from the experience of 1960. It will be recalled that, despite the existence of considerable slack in the economy, monetary policy was quite restrictive, a long-term government bond issue was sold in the fall of the year, and an inappropriate N.H.A. rate and virtual withdrawal of CMHC from direct lending had curtailed housing activity. Taxes had been increased in mid-1959 with the result that the federal budget was virtually balanced in the first half of 1960 (on a national accounts basis), despite the existence of unemployment rates in excess of 6½% of the labour force; in fact, about half of the increase in Gross National Product in the previous two years accrued to the federal revenues, and this exercised a considerable drag on the economy. In the light of this mix of policy, it is not surprising that the economy's performance was sluggish, that our currency was at an inappropriately high level in the foreign exchange market and that capital inflows were unusually large for a recession period. The resulting public discontent led to the adoption of the various specific measures, discussed in earlier chapters, which unleashed a host of difficult consequences; significantly, however, the economy did not really respond until the broad set of general policies was changed subsequently.

One can also recall other periods when the posture of policy resulted in some sacrifice of national economic objectives. One example was the 1955-57 boom when no deliberate fiscal restraints were employed, debt management measures eased credit conditions and monetary policy was insufficiently restrictive. There have similarly been occasions when the federal budget has seemed contradictory—for example, by containing incentives to stimulate output on the one hand but lacking any general reduction in tax burdens, or even containing net increases, on the other hand. In making these points, we are not denying the usefulness of vigour and imagination on the part of the authorities. Nor are we arguing that fiscal policy should not be selective or that specific measures may not sometimes be valuable supplements to broader policies. We are simply stressing that if policy is not set to exert the right influence on total demand—as opposed to its composition—and to create the right general climate, no amount of more direct intervention is likely to lead to the achievement of our employment, price and other national objectives.

In earlier chapters, we pointed out that the effectiveness of the different policy instruments working separately was frequently limited. In particular, monetary and debt policies do not have powerful enough effects—within the range that they can be used without incurring international complications—to be counted upon to stabilize the economy unaccompanied by other policies. Moreover, the way in which individual components of policy are used has important effects in any event on the jobs which the others are called upon to do. Haphazardly co-ordinated measures can thus have unfavourable repercussions on both domestic and international confidence which sooner or later will be reflected in reduced economic activity in Canada. Policy must thus be cohesive and co-ordinated, and the various elements of government cannot be narrowly concerned with just one objective while leaving the others for some other body to look after. The monetary, fiscal and other authorities each have special responsibilities, but only within the context of how they can help to achieve broad national goals. None should be allowed to develop separate or isolated aims of their own since unbalanced attention to one major objective—or, still worse, to subsidiary or minor aims—will almost certainly prevent the attainment of the nation's wider economic objectives.

A planned, complete and consistent program of policy will take account of all the many interrelations between policies. We have shown, for example, how changes in fiscal policy affect credit conditions, debt management decisions and our international financial position; how the effects of government cash surpluses or deficits on national spending are only fully realized if coupled with the appropriate monetary policy; and how changes in the maturity of the federal debt have implications for other monetary measures and credit conditions generally, and—through them—on domestic spending and the balance of payments. In Chapter 23, we also outlined the many relationships between domestic policies and the international financial position and how the relationships worked themselves out under both fixed and floating exchange rate systems. Similarly, other government policies—measures dealing with matters as varied as trade and tariffs, vocational training and combines legislation—can have important repercussions on both the domestic economy in general and our international competitive position in particular, and thus on the freedom and effectiveness with which the monetary and fiscal authorities can devise measures to maintain full employment. Finally, banking and financial legislation affects the type and amount of capital available in Canada at given rates of interest and thus affects domestic spending and our resort to foreign capital. If action in any one field of policy—financial or non-financial—is taken without regard to the consequences in others, the results are therefore likely to be unsatisfactory, both in themselves and because of the uncertainties they create.

Earlier in the report, we gave some illustrations of occasions when post-war policies appear to have been but imperfectly co-ordinated, for example in the inflationary years right after the war when an easy monetary policy provided no assistance to a restrictive—perhaps insufficiently restrictive—fiscal policy. The situation was reversed in some of the years after 1957 when expansionary fiscal measures were partially offset by tight credit policies. Indeed, at times in the post-war period it has seemed that unnecessary burdens have fallen on one or the other instrument of policy because it has been politically inconvenient to take the necessary steps in other areas. This has not always been the case, and it is only fair to point out that on occasions—like the outbreak of the Korean War or in late 1957—fiscal, monetary and other measures have been used harmoniously, if not always vigorously enough. Such occasions seem to have been altogether too rare, however, even allowing for circumstances like the summer of 1962 when a conflicting combination of policies was consciously used by the authorities, with credit conditions having to be tightened for international reasons despite the slackness of the domestic economy.

FACTORS INFLUENCING THE CHOICE OF POLICIES

We do not want to suggest that improved co-ordination will provide an answer to all the policy-makers' problems. There have been shortcomings of policy even when there has been the maximum of co-operation and consultation within the federal government, and these deficiencies have sometimes arisen from an unwillingness to deal appropriately with difficult situations. Granted however, that there is no unwillingness to take the necessary steps, the major difficulty confronting the authorities is that of assessing the emerging situation and judging what measures are necessary to handle it. We have tried to stress that this is a matter of discretion, not of formulae. Each set of economic circumstances has its unique qualities, and remedies which work in one situation will fail in another. Clearly, much will depend on developments and policies in the rest of the world, especially the United States, on the structure of the domestic economy and how it is changing and on public attitudes and confidence; these in turn will be shaped by recent experience and policy at home and abroad. It would thus be unreal and dangerous for us to attempt to prescribe policy for an unpredictable future. The costs and benefits of pursuing one objective rather than another are always changing and the effectiveness of individual policy instruments will vary widely with the circumstances.

If it seems unsatisfactory that we can put forward no precise and detailed formula for policy, it will appear even less satisfactory that we are unable to establish an unchanging yardstick by which to judge our success in meeting national objectives. Nevertheless, objectives which are easy to reach in some circumstances may prove impossible to attain in others. For example, seasonally-adjusted unemployment rates as low as 3½% of the labour force may well be reached without inflation in a favourable world environment if structural problems are minor and both labour and management are moderate in their demands, while even 5% may be almost impossible to achieve in the reverse circumstances, particularly if the labour force is growing rapidly. Much the same applies to productivity gains which—for reasons beyond the control of policy—can vary significantly in the short run from a satisfactory long-term average. The objective of maintaining a sound external financial position naturally cannot be reduced to purely quantitative terms at any time: it involves many separate component aims relating to our competitive position, reserve holdings, dependence on foreign capital and international trade and payments arrangements generally.

Nor is there any rigid order of priority which we can assign to objectives in the event of temporary or more lasting conflicts between them. International considerations may predominate temporarily, and may at times need to receive primary emphasis for more extended periods, especially if the economy has become uncompetitive internationally. In normal circumstances, however, we would be inclined to give priority to the employment objective because of the high costs of unemployment in terms of personal hardship and lost national output, although we have tried to show that this objective is not independent of the others. If the international competitive or financial position is weakening, if productivity gains are low or non-existent, or if prices are continuing to rise significantly, more attention must be paid to solving these problems. Not the least reason for doing so is that failure can inflict lasting damage on the chance of attaining high and stable levels of employment.

Despite the impossibility of laying down a set of unvarying rules of policy to meet differing situations, there are certain broad classes of problem which will continue to be encountered in Canada. It may therefore be helpful to sketch in the sort of policy approach we believe will be necessary in dealing with them. We first discuss the problem of insufficient demand and unemployment, and then discuss the opposite problem of excessive demand and rising prices.

(i) *The Problem of Insufficient Demand*

If a slowing rate of growth in exports and domestic investment, rising unemployment and other indications suggested that mild and short-lived weakness in general demand was imminent, the solution might be comparatively simple. The situation might call for some easing of credit conditions (including the termination of any voluntary or legal restraints on credit terms and lending imposed earlier), a speeding-up of useful and reversible public works and, perhaps, a temporary tax cut to stimulate consumption. The job of the authorities would be made easier if conditions in the rest of the world were buoyant, our international cost position were competitive, and our foreign exchange reserves were large, since domestic expansionary policy would then be freer of external limitations. The same would be true if international payments arrangements allowed us ready access to any necessary reserves on a temporary basis. Expansionary measures would also be facilitated if labour and management were showing restraint, so that price stability were not threatened, and if public confidence in past and prospective government policies were high.

If there were prospects of a prolonged period of weakness—say because an extended investment boom had led to substantial over-capacity in industry—it would be much more difficult to find effective remedies. The degree of monetary ease would have to be greater, government debt issues would need to be confined as far as possible to shorter maturities (a task facilitated if earlier policy had extended the maturity of the debt) and greater reliance would need to be placed on fiscal measures. A program of financial incentives to, and co-operation with, the provincial governments to encourage them to expand their social capital outlays would also play a vital role.

The complexities would be even greater if there were widespread structural problems in the Canadian economy because of changes in domestic and world demand. The essential general measures would need to be supplemented by special steps to improve the mobility of labour, to up-grade the skills of the population and, perhaps, to provide industrial incentives which did not lead to high-cost production. Despite unemployment in many areas, there are still shortages in many skilled occupations in Canada, and re-training programs can be used both to increase employment and to prevent shortages of certain classes of workers from pulling the whole wage and price structure upwards. Such retraining, however, need not always emphasize particular skills—general adaptability and a command of language and elementary mathematics may well be more useful to some workers in an age of computers.

In devising policies appropriate for the country as a whole, the authorities will also have to take account of regional problems. Seasonally-adjusted unemployment rates in November 1963, for example, were 9.5% in the Atlantic region, 7.2% in Quebec and 6.2% in British Columbia compared to 3.6% in Ontario and 3.1% on the Prairies. The extent to which both regional, and seasonal, pockets of unemployment can be eradicated will clearly play an important role in determining how successful we are in attaining full employment levels on a national basis. In this endeavour, general fiscal and monetary measures have little part to play beyond maintaining an appropriate broad level of demand. Federal taxes and services cannot easily be different in different parts of the country, nor is it possible to conceive of a meaningful regional monetary policy given the essential unity of capital markets and the readiness of capital to flow to the centre offering the best return. However, regional development funds may be useful if it is desired to create enterprises which are either not able to pay going interest rates or which are being established for other than economic reasons. It should be noted, however, that we did not find significant evidence that an inability to obtain capital was the basic difficulty in regions of the country characterized by high unemployment.

Measures designed to keep the economy competitive and adaptable have a particular importance because if our cost structure is high, it becomes still more difficult to pursue policies

designed to stimulate employment and output in Canada. More rapid increases in domestic prices than those elsewhere would quickly impose external limitations on expansionary measures. These external limitations will also be severe if our reserve position is weak or the world environment unfavourable. Our reserves would be under still greater pressure if Canadian credit conditions were eased much more than those in the United States, because of the substantial and prompt reaction of international capital flows to significant changes in interest differentials between the two countries.

Although the interest-rate links between Canada and the United States are not rigid and the external environment will not always frustrate our domestic policy, it is only realistic to recognize that international considerations will frequently limit the range over which Canadian credit conditions can be allowed to move, even when supported by operations in the forward exchange market. This limit will be encountered sooner, and be more severe, if the United States is following inappropriately restrictive credit policies, perhaps out of concern about the size of its gold stock or its international position generally. This possibility serves to stress the importance of developing adequate international liquidity arrangements. Not only would they directly give Canada and other countries more time and freedom to correct fairly deep-seated difficulties, they would also have important indirect benefits: the major industrial countries would not be as likely to impair world prosperity by pursuing inappropriately restrictive policies in a fruitless attempt to attract a limited stock of world reserves from each other.

We therefore hope that the occasions when international considerations require us to set monetary and fiscal measures in a different gear, or even in a different direction, will be infrequent. Our evidence does not suggest that any single instrument of policy is so powerful that we would want to use it in virtual isolation if this can be avoided. On the other hand, the very fact that monetary policy normally has limited effects on real expenditures—as opposed to financial flows—means that it can be used perversely from a domestic point of view in order to restore a temporarily unbalanced international financial position or to gain time for more fundamental measures to take effect. This was the case in the speculative exchange crisis of 1962: while monetary restraint's impact on the domestic economy on that occasion was substantial, it did not so dominate events that the business recovery then under way was interrupted. The position would have been different if failure to take other action had resulted in this policy being a lasting one.

The existence of international limitations on the easing of credit conditions, and the apparent inability of monetary policy even without these limitations to restore the economy to full employment levels in a period of serious slack, both suggest that fiscal measures must carry a substantial burden at such times. To some extent, an additional easing of credit conditions without major interest rate effects might be achieved through such steps as lowering N.H.A. downpayments and making I.D.B. loans more freely available, but the most direct and immediate effects on domestic incomes and expenditures will probably have to come from the fiscal side and include substantial tax cuts.

We are not willing to contemplate the use of foreign exchange controls on capital or commodities in peacetime: quite apart from their limits on freedom, they invite retaliation, may lead to high-cost production and impose lasting damage on capital flows. The federal government may be able to add just as much to our reserves by borrowing funds in the long-term market in New York. Even if the United States government is concerned about its own reserve position, it might not object if the reserves borrowed in this way by Canada were likely to flow back to the U.S. as a result of our deficit position. Whatever the situation, however, it is important that the two countries agree to cooperate in managing their reserve positions so as not to impose unnecessary difficulties on each other; Canada recently played a constructive part in this process by reducing the share of gold

in its reserves to ease the strain on the U.S. gold stock.

In extreme circumstances—for example, if a serious weakening in world demand for Canadian exports occurred—it might be necessary to change the foreign exchange value of the Canadian dollar. We hope that constructive world and domestic policies will not make this necessary, but there may be times when it is not sensible or possible to defend the value of the exchange rate through restrictive policies which result in excessive unemployment and stagnation at home. This, however, should not be taken as an excuse for mismanaging the domestic economy; if the exchange rate is allowed to depreciate needlessly under any rate system, it can result in increasing domestic costs and prices and an undermining of confidence which become cumulative and dangerous to employment and growth.

(ii) *The Problem of Excessive Demand*

The problem of excessive demand, like that of inadequate markets, can be of varying intensity and difficulty. If the period of actual strain on real resources and of rising prices is expected to last for only a year or two, it may be relatively easy to handle by tightening credit conditions fairly early in the upswing, cutting back some government expenditures and, if necessary, by increasing taxes. Our exchange holdings might well increase substantially if capital flows exceeded the current account deficit, but a temporary increase could be handled readily, especially with some international cooperation; such reserve gains might indeed be welcome if the initial position were weak.[1] On the other hand, it is possible that our reserve position might weaken in a domestic boom—thus minimizing the conflict between domestic and international objectives—although this has not been the usual pattern of our experience.

The task of the authorities would be more difficult if the period of inflationary strain seemed likely to be prolonged or if it followed soon after a similar recent experience. Moreover, if the world environment were also inflationary, Canadians might come to expect further price rises and both labour and management might become less competitive and less restrained in their attitudes. The resulting price and wage increases would be intensified by pressure from abroad—psychological as well as economic—and would call for more lasting and pronounced fiscal measures on both the expenditure and tax side, including perhaps reducing depreciation allowances and imposing special taxes on investment goods. The federal authorities would also need to seek the aid of the provincial and municipal governments in reducing the pressure on real resources. In addition, monetary policy would need to be highly restrictive, although limitations on the use of this instrument might be encountered in the form of embarrassing inflows of capital and exchange reserves. The extent of this limitation will depend in part on policy being followed elsewhere. If U.S. policy, for example, is also restrictive, we will have more freedom to raise domestic interest rates; if, however, American rates are kept unduly low—perhaps because of concern about the reserve position of the rest of the world in the absence of other international arrangements—our freedom to manoeuvre will be correspondingly reduced.

If these international limitations seriously limit our ability to use general monetary measures to restrain critical inflationary pressures, we would not rule out the use of more selective instruments with less interest rate consequences. These might include direct measures to restrict the type and amount of credit granted by financial institutions and changes in the terms of N.H.A. lending. (We do not know whether consumer credit regulations lie within the federal power, and in any event a general increase in sales taxes might be more equitable and just as effective). We

[1] The problem of excess reserves would be less intense in the unusual situation of a period of inflation in Canada coinciding with a period of relative slack in the rest of the world. The resulting relative weakness in export demand and strength in import competition would tend both to check Canadian price increases and our rate of reserve accumulation.

indicated in Chapter 22 that we have reservations about the imposition of asset ratios and the use of moral suasion because of their interference with the development of the capital market, their discriminatory effects and the evasions and grey markets to which they may lead. Nevertheless, if conditions are sufficiently serious and the authorities are prevented by international considerations from tightening up the financial system in the usual way, such measures may be needed. However, they should in our view be subject to governmental concurrence, be temporary in nature and so far as possible be applied equitably to all institutions doing a similar business.

The government's debt management operations, while perhaps playing a minor role on balance, should also be used where possible to bring about the appropriate credit conditions. For example, refunding maturing issues into longer-term securities may help the monetary authorities to put the maximum pressure on long-term interest rates, which appear to have more influence on domestic spending, while at the same time reducing the pressure on shorter rates, which are most relevant for some types of international capital flows. If excess reserves were used to repay the external indebtedness of the federal government in such circumstances,[2] it might alleviate speculative forces and reduce the pressure from the United States for us to ease our policy because of the drain it created on their reserves and thus give us more scope to pursue restrictive credit policies.

We have stated in Chapter 23 that we do not favour directly interfering with capital inflows to meet the problem of excessive additions to reserves. Although such measures can be highly effective in the short run, they also have enduring effects which might prevent us from obtaining needed foreign capital when circumstances subsequently change. In fact, if resisting upward pressure on the Canadian dollar in the exchange markets should seriously weaken our ability to pursue domestic objectives and result in significant irreversible increases in Canadian prices and costs, the authorities might finally have to revalue the dollar. We do not favour frequent changes under a fixed exchange rate system, with all their accompanying disruption, and it may well be possible to avoid them by a combination of counter-speculative measures, international co-operation and appropriate fiscal policy. Should this prove impossible, however, without inflationary damage to our international competitive position and to the maintenance of full employment in the longer run, some change might be unavoidable.

It is all but certain that prolonged periods of strain on Canada's resources—whether or not they ultimately necessitate revaluation of the currency—can only be combatted effectively by a mix of policy in which fiscal measures are prominent. Monetary policy is just not powerful enough to do the job by itself over any reasonable range of credit conditions, even if there were no international inhibitions about using it fully. This makes it particularly important, as we stressed in Chapter 24, that fiscal policy be used wisely and with foresight. Irresponsible and irreversible spending commitments undertaken in recession periods will limit the ability of governments to run the necessary surpluses at reasonable levels of taxation in times of boom. If the federal government adds to the strain on resources and absorbs domestic savings in buoyant times, or if it raises taxes to intolerable levels, our long-run growth may well be undermined and domestic ownership of the economy reduced. Moreover, failure to plan ahead will have adverse effects on domestic and foreign confidence and financial markets which will limit fiscal policy's possibilities and its effectiveness in times of future weakness in economic activity. While we think deficits desirable when they employ savings and manpower that would otherwise go to waste in recessions, we have no sympathy for the view that this justifies a Minister of Finance in embarking on projects which he is not prepared to tax for or to curtail when circumstances require.

[2] Other borrowers are unlikely to do so, since it is precisely at such times that they find difficulty in meeting even their needs for new funds in the Canadian market.

(iii) *Other Problems of Policy*

It has sometimes been suggested that varying the emphasis given to monetary and fiscal measures can help to foster the goal of rising productivity in the long run. There is some scope to make such alterations in the "mix" of policies, and, as we have indicated, such variations may indeed be necessary to reduce conflicts between domestic employment and price objectives and the international goals. However, there are limits to this freedom and in any case there can be no certainty as to which combination will lead to the highest rate of productivity growth in all circumstances.

Increased efficiency is largely a result of the energy and enterprise of labour and management, of skills, education and research, of technological developments in Canada and elsewhere, and of the adaptability of our citizens to new situations. Government financial policy plays some part in this process through its impact on the incentive to invest in new capital facilities, upon which increased efficiency and employment in large measure depend. Thus fiscal policy—the amount and type of government expenditures and revenues—can influence the amount of savings, investment and consumption in the economy, while international financial policy—particularly that relating to capital flows—can have similar effects. Monetary policy also has some influence on productivity trends insofar as they are dependent on capital investment and capital investment is sensitive to the cost of borrowed funds.[3] However, more direct government influences on productivity are usually exerted by non-financial policies—measures affecting education, labour mobility, and the general flexibility of the economic environment. Trade policy in particular has a special role to play in ensuring that the economy remains competitive and that high-cost production is not fostered.

Whether a restrictive fiscal policy and easy credit conditions will lead to faster productivity gains than the reverse combination (employment, price levels and other policy assumed equal) will depend, for example, on the nature and impact of the extra taxes involved. They may fall on consumption, investment or savings with varying degrees of intensity or they may more generally affect the willingness of citizens to work and innovate. Similarly, if some part of the fiscal restraint is achieved by curtailing expenditures, the net effect on productivity will depend on the usefulness of the spending eliminated and of the private spending which replaces it. If fiscal restraint does not greatly affect investment incentives or reduce productive public expenditures, and if productive private investment responds to the easing of credit conditions created in part by government surpluses supplementing private savings, the result may well be higher productivity gains than are obtainable with some other combination of policies.

Yet it is equally possible to imagine circumstances in which rising efficiency would best be promoted by easier fiscal policy and more restrictive credit conditions. Quite apart from the possibility that it might have less adverse effects on incentives, it would probably attract more foreign capital and thus enhance capital formation in Canada. Similarly, if the increased fiscal outlays relieved shortages in the government sector, this particular mix might result in more rapidly rising productivity than policies designed to stimulate growth of a stock of private capital already relatively high in relation to demand. In fact, fairly expansionary budgets and high interest rates —much higher than those in Canada—have been the policy in a number of European countries in recent years.

Under either combination of policies, the longer-run set of fiscal policy can be used to discourage consumption and encourage saving at full employment levels. If pushed too far, however, this approach can blunt the desire to work and so weaken consumer demand that business-

[3] See, for example, the Submission of Professor Paul Samuelson—p. 43, para. 3—in which he states that faster growth, if it can be achieved at all, must depend upon monetary policies designed to stimulate a long-term deepening of capital; the corresponding reduction in the proportion of consumption in total output at full employment levels would be achieved by a tighter fiscal policy.

men have no incentive to invest in new and improved capital facilities. In any event, we do not believe that the authorities will normally have great scope for altering the mix of policies without sacrificing one or more of the major national objectives. To the extent that a wide area of choice does exist, the mix which is most appropriate can only be determined in the light of the particular circumstances prevailing at that time.

An important factor in the choice of policy will be the extent to which the goal of price stability can be reconciled with that of high employment. Although there is no inherent or rigid conflict between the two goals, we noted in Chapter 20 that prices do show some tendency to rise when unemployment ratios get much below 4% to 5%. How much prices will in fact rise will depend largely on management and labour attitudes. This in turn will depend in part on the world environment, on the competitiveness of domestic and export markets and on the structure and adaptibility of the labour force. Despite "the age of automation", productivity gains recently have been less than those in many other periods of our history, although the pace of increase may accelerate in future. The period ahead will also be one in which the additions to the labour force will be even larger than in recent years.[4]

If rapid technological change, substantial additions to the labour force and competitive business conditions do not in fact significantly reduce the conflict between the price stability and full employment goals, the authorities will be faced with difficult decisions. If they restrict total demand to curb undesirable wage and price increases, additional unemployment and economic slack may result. On the other hand, if they fail to stop the process, our international competitive position and basic willingness to save and invest may be undermined—with consequent repercussions on our ability to maintain full employment at rising standards of living in the future. It is thus important to ensure that money wages and prices do not rise unjustifiably if the authorities wish to be free to pursue full employment policies effectively.

In an attempt to deal with this problem, a number of countries have introduced "incomes policies", which we discussed with some of our distinguished foreign witnesses. In some cases, these policies amount to nothing more than guide lines as to the appropriate rate of annual wage increases which can be granted without inflationary stress; these are determined by bodies representing the various interests in the community. In others, wages and prices are more directly controlled by the government.

Even the more voluntary arrangements seem to depend in large measure on agreements between highly-centralized trade union movements and confederations of employers. They would thus not be adaptable without change to the Canadian situation in which autonomous unions bargain with individual employers or industries,[5] and in which labour contracts are—with few exceptions—a matter of provincial jurisdiction. The results are not always satisfactory in any event—political pressures frequently leading to large annual wage increases—and most of the countries involved have much more rapid rates of inflation than Canada or the United States. Any attempt to freeze wage differentials also leads to unrest and injustice and to the danger of misallocating resources in changed circumstances. Professor Lundberg told us, however, that Sweden avoids some of these dangers by maintaining a highly competitive atmosphere which squeezes workers out of declining industries and gives them government assistance to relocate. Nevertheless, he admitted there are wage "slides" as employers try to obtain scarce labour by bidding over the going rate.[6] If provision is made for independent arbitration, moreover, the arbitrators are not likely to be guided solely by government policy and the system may well break down under the pressure of exceptions. Finally, as the late Sir Dennis Robertson reminded us, it is virtually

[4] In the six years from July 1957 to July 1963, more than 800,000 people were added to the working population outside agriculture.

[5] The Canadian Labour Congress, for example, has no authority or control over any of its affiliated unions with respect to their collective bargaining policies—Transcript, page 6514.

[6] Transcript, pp. 4285-97, 4361-7.

impossible to have an effective and acceptable wages policy without also having a profits policy, which may well freeze earnings in an inappropriate pattern and remove much of the incentive to expand and improve efficiency.[7]

The whole question of wages and incomes policies and their place, if any, in the armoury of government policy requires more study than we have been able to give it. However, it is clear that formidable difficulties and costs are involved in establishing such sweeping new arrangements, and we have the impression that they are not necessary or desirable at this time. This does not mean that the problem can be ignored, but we think that a combination of general financial policies, non-financial measures and reasonable self-restraint on the part of labour and management can prevent any tendency for excessive wage and price increases to reassert themselves. The recently-established Economic Council of Canada should be able to play a constructive role in this area by studying the problem and making the public and the parties involved aware of the issues. Its periodic studies of Canada's domestic and international economic position should also serve to alert those engaged in wage negotiations and pricing policies to both the short and long-term implications of their decisions.

Such studies will not, however, relieve the authorities of their obligation to use their general policies to maintain effective demand at appropriate levels. Nor will they relieve the government of the obligation to use non-financial measures to keep the economy adaptable and competitive. The task facing the authorities will thus be complex at virtually all times. It may involve the use of many instruments of policy, depending on the structure of the economy, the number of subsidiary goals sought, and the "feedback" effects of individual policies designed particularly to promote one objective on the likelihood of attaining others.

The authorities will also be confronted with choosing from a wide range of techniques to implement these policies. As we have argued in earlier chapters, they must try to choose those which do not create confusion or lack of confidence and thus put unnecessary limitations on the effectiveness of policy. Nevertheless, the choice of operating techniques used is of secondary importance to the task of establishing the correct climate of policy in a carefully-planned and consistent way. If 4% is the right level for short-term rates, it matters little whether they are achieved under a fixed or floating bank rate system, although it may be easier to obtain public acceptance under the former. Similarly, if long rates must be increased, it will depend on the circumstances whether this is best achieved through new issues of long-dated government bonds, tightening up short-term rates, direct open market operations or some combination of these techniques. The end result may not be very different, and the choice should be made in terms of which technique is the most suitable and least disruptive. Whatever the choice, the authorities should not bind themselves unnecessarily to rigid operating rules or techniques; within the scope of their legal powers, the sole test of methods they use should be whether they will best achieve the ends of policy in an acceptable and effective way.

THE ORGANIZATION OF POLICY-MAKING

We stressed earlier that even well-chosen policies will be effective only if our political leadership is wise and far-sighted, willing to consider its actions and their consequences carefully, and—if necessary—prepared to take steps that are temporarily unpopular. If the national interest calls for restrictive policies in the form of higher taxes or tight credit conditions, this will rarely be applauded. If a recession leads to demands for permanent and unwise government expenditures on the grounds that they will help to combat the current weakness in demand, it is not easy to refuse. Yet the long-run consequences of failing to take a firm stand may be serious, and the Minister of Finance must be a man whose suspicions are aroused if his tax and expenditure policies suddenly become too popular. He has also a special responsibility to ensure that rival

[7] Transcript, pages 5146-58.

economic policies do not develop within his own sphere of responsibility, although it is on the Cabinet as a whole that the final responsibility for the unity, coherence and good sense of policy must rest.

The best of political leadership will, however, be ineffective if it does not have the support of an informed and intelligent public opinion. The government itself has an important role to play in this process, by the timely release of statistical and other economic data, by informative discussion of its policies in and out of Parliament and by encouraging its officials to explain its policies and participate in discussions with interested members of the community. Nevertheless, a large measure of responsibility for creating a sensible public interest in policy must rest with the private sector—business, labour, the academic community and the press. Some private organizations do play a useful role in studying and commenting on policy issues, but we have the impression that more useful commentary could be made.

It seems to us also that the Canadian academic community all too rarely takes a leading part in stimulating informed discussion of economic policy matters, especially in monetary affairs. We realize that the number of economists who are not working on government assignments at any point in time is limited, but we hope they will play a more active role in public discussions of policy. Finally, the financial press in Canada could with great advantage to the country devote more resources to informed and intelligent assessment of economic policy issues. Canada is still a small country, but there is no reason why its financial press could not improve the standard of commentary and analysis of financial policies and developments.

A third essential ingredient of good policy is the existence of an adequate and well co-ordinated staff of policy-making advisors, equipped with prompt and relevant information on which to base its recommendations. Canada's statistical services have greatly improved since the days of our predecessors on the Macmillan Commission; data are now available, for example, on the labour force, national production, the annual investment outlook and a wide range of financial and industrial affairs, much of them seasonally-adjusted. Yet, the increasing complexity of the economy, and the increased policy responsibilities of government, have led to a still greater increase in the need and demand for statistics; this comes not only from the federal government itself but from the private sector, other levels of government and even international bodies.

We therefore find ourselves in sympathy with those recommendations of the Royal Commission on Government Organization designed to increase the funds, personnel and other resources devoted to the collection and publication of statistics by the federal government.[8] From the viewpoint of economic policy, the main concern is not the quantity of data available but its promptness and relevance. In Chapter 22, we cited some of the delays involved in present publication schedules of economic information and indicated how this handicaps the authorities in determining what is actually happening in the economy, and therefore what the posture of policy should be. While agreeing with the general view that the Dominion Bureau of Statistics is on the whole doing an excellent job with the resources at its command, we hope that it will be found possible to accelerate the production of the main statistical series and make more resources available for this important task.

There also appear to be some gaps in the statistical data needed both for short-term policy decisions and for an assessment of the longer-run trends in the economy. We have mentioned a number of examples in earlier chapters, among them the need for quarterly government cash requirement data on a seasonally-adjusted basis, for uniform information on the financial position and capital spending of provincial and municipal governments, and for quarterly data on the financial position of non-financial corporations. The task of the authorities would also be eased if

[8] *Report of the Royal Commission on Government Organization* (Glassco Commission), Vol. 3 pp. 35-51.

the survey of investment intentions were carried out quarterly, if good data on new orders, inventories and shipments were available sooner, and if prompter and more detailed information were available on financial institutions other than the chartered banks. There have been recent striking improvements in this last area, but there are still gaps, especially with respect to the credit unions and caisses populaires. For longer-term purposes, it would be helpful to have more information on the conventional mortgage market and on the financial position and problems of agriculture and small business.

In general, we believe that improved and extended statistical series, particularly in seasonally-adjusted form, can help businessmen to make more intelligent decisions about their investment and inventory policies. They thus may make a contribution to stabilizing the flow of economic activity by reducing the possibility of excessive bunching of private spending as well as by assisting government policy-makers to pursue improved stabilization policy.

Important though good data are to the policy-making process, much depends on the calibre and vigour of the personnel in the public service. The Canadian public service is rightly held in high regard in Canada and abroad, but we have the impression that the policy-making departments are not now attracting and retaining sufficient numbers of able men to handle their increasingly heavy responsibilities.[9] This is only partly the result of the increasing challenges and opportunities open in the private sector. It also stems from the insufficient time and attention paid to recruiting and development by overworked senior officials in the public service and from the inflexibility of civil service recruiting procedures, pay schedules and promotion policies. In any event, as the Glassco Commission observed, many of the most able persons in the public service today were recruited during the depression and immediate post-war periods.[10] They have served the country well, but it is essential that future needs for qualified senior personnel not be obscured by the very fact of the unquestioned talents of those now in top-level positions. Steps should therefore be taken—along the lines recommended by the Glassco Commission—to develop improved and more flexible personnel policies in the civil service to make it possible to attract and retain the most highly qualified men available and ensure that those in senior positions have the necessary skills and temperament to discharge their burdensome duties well.

We also share the impression of the Glassco Commission that the Department of Finance is understaffed and lacks sufficient personnel to undertake more fundamental research, particularly on longer-run problems. This is partly the result of the constant pressure to carry out *ad hoc* investigations when unforeseen and urgent problems arise. Some of these longer-range functions will undoubtedly be carried out by the new Economic Council. This body is charged with studying, and advising the government on, such matters as the medium and long-term prospects of the economy and the policies which can help to attain the nation's major economic objectives. It also has a series of more specific instructions to deal with such subjects as Canadian ownership of industry, automation and technical change, patterns of change and investment in individual industries, regional development, major investment projects and labour-management relations. In addition, it is charged with fostering improvements in productivity and management techniques, the training and re-training of labour, the extension of research and a number of related matters.[11]

The Council's studies and annual reports, including an annual review of medium and long-term economic prospects, should contribute significantly to increased public awareness about policy issues and lengthen the perspective from which they are viewed. The Council will no doubt perform much the same useful functions for the main policy-makers in Ottawa, although its exact position in the policy-making process will only be

[9] The Bank of Canada's organization will be discussed separately in the next chapter.

[10] *Op. cit.*, Vol. 1, page 246.

[11] See the governing legislation, Bill C-72, 1st Session, 26th Parliament, 1963.

established with experience. The Council, composed of three full-time members and twenty-five representatives of various interests in the community, will have its own staff and presumably will be a source of independent advice to the government, to which it reports through the Secretary of State. However, because it will have no specific operating responsibilities in the policy field, its members will also be free to participate in public discussion of policy in a way that is not possible to departmental staff, whose advice must be given in private and who cannot become embroiled in public controversy. In this respect the Council will not be unlike such semi-independent advisory bodies in a number of European countries, although we hope it will work closely with the policy-making departments and the Bank of Canada.

However, as Professor Samuelson stressed to us,[12] outside committees, no matter how distinguished their membership, should not be allowed to determine policy or to blur the responsibility of government for making decisions and accepting their consequences. As an additional advisor and as a means of focussing attention and initiating discussion on policy issues, the Council will undoubtedly play a constructive role, but the Minister of Finance should always have the central place in the making of economic and financial policy. It is he, after all, who is responsible for monetary and budgetary policy, the two main instruments of economic stabilization.[13] It is thus important that the Minister of Finance have a strongly-staffed department, whose personnel are capable of undertaking more policy studies of a long-range nature, no matter how close their working relationship with the Council. Both the Finance Department and the Council might usefully strengthen their staffs by bringing in outside experts from the academic community, from business and from the labour movement to serve with them for temporary periods, say up to two years. This practice is followed extensively in the United States, and to a lesser extent in the United Kingdom, and leads to both a freshness of approach and a more practical understanding of policy problems both in and out of government.

[12] Transcript, pages 6323-7.

[13] The situation is different in the United States where the President has final responsibility for all policy, subject to legislative approval where required. The Council of Economic Advisors are full-time government appointees charged with advising the President on economic affairs, and are frequently used to defend the Administration's policies in partisan forums.

CONCLUSION

Even with effective policy-making arrangements, many obstacles to the formation of good policy will remain. The authorities can never be certain of our exact position in the expanding universe of economic events, and—despite significant improvements in the art of forecasting—predictions of the future inevitably retain a pronounced Delphian quality. However, we do not believe it impossible to get the broad set and timing of policy right—a few months in which the direction or strength of policy later proves to have been wrong are not catastrophic. Moreover, the record shows that the major errors of the post-war period have arisen in large part because of a reluctance to use the general policy instruments appropriately or because hasty and haphazard expedients have been resorted to when well thought-out and carefully co-ordinated programs would have accomplished the task more satisfactorily.

There will be limitations too, on the use of policy because a free and diversified society is unlikely at all times to be unanimous on the objectives to be pursued and the means of accomplishing them. We have argued, however, that these difficulties can be minimized by effective leadership and a conscious attempt to show as far as possible the costs and benefits of pursuing one aim rather than another. An enlightened public opinion and financial community are unlikely to put serious limitations on the use of monetary and fiscal measures over a fairly wide range. It is for this reason that we have stressed the importance of fully explaining policy and its goals so that, for example, the authorities are not forced into balancing the budget at times when to do so would only unbalance the econo-

my and create unemployment. It would be equally undesirable if the authorities were compelled by uninformed public demands to keep interest rates unduly low in the reverse circumstances when to do so would only result in inflation and later difficulties.

A third major limitation on policy and its effectiveness will from time to time be imposed by the international environment. We have, however, indicated that shorter-run problems of this kind can sometimes be met without serious damage to the domestic economy by varying the mix of policy to put more emphasis on fiscal measures and by the development of more extensive international financial arrangements. In more extreme and prolonged circumstances, however, changes in the external value of the currency might prove necessary to relieve some of the strain on the domestic economy. Yet, the fact remains that we are connected to the world economy whatever our currency arrangements, and if the world economic environment is unfavourable, the Canadian economy will perform unsatisfactorily despite the best efforts of the policy-makers.

The use of policy in the circumstances of any country involves substantial difficulties and is likely to achieve something less than the ideal. The Canadian authorities are subject to additional restrictions because of our extreme openness to world conditions, particularly those in the United States. Our economy has outperformed theirs in much of the post-war period, in part because of our ability to draw in and displace imports in periods of rising and falling activity respectively, but it will always be difficult for Canada to do significantly better than the United States. Nevertheless, we should be capable of doing at least as well, and prolonged failure to do so would raise questions about the effectiveness of our domestic policies.

Despite the lags, uncertainties and limitations of policy, our view is essentially a fairly optimistic one. We believe that discretionary policy, wisely used, can improve our economic performance and that reasonable economic objectives are not beyond our ability to attain by such means. We have no reason to believe that discretionary decisions will so often be wrong or perverse that more would be accomplished by replacing them with automatic rules of action relating to the maintenance of a given level of interest rates, to specified annual increases in the money supply or to some other factor. Indeed, we have argued that automatic or mechanical guides are inadequate to cope with constantly changing economic situations and political preferences. Moreover, only in operating policies in the light of varying conditions will the authorities gain the experience needed to deal with new and difficult situations.

We have found that each individual strand of policy has effects sufficiently powerful that it cannot be a matter of indifference if it is wrongly set or ignored. At the same time, we have stressed that no one element of policy has results so strong that it can be relied upon in isolation. Incoherent or incompatible policies will thus have serious results for the economy. If taken together and carefully co-ordinated, however, the stabilizing potential of all policies can be large in relation to the swings in economic magnitudes that would otherwise occur—larger indeed than the sum of the effects of the individual component policies. Conversely, the results of a program of policy which is wrongly conceived can be serious.

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CHAPTER 26

THE STATUS AND ORGANIZATION OF THE BANK OF CANADA

We have emphasized that policy is composed of many diverse strands which must always be closely interwoven—although in different blends at different times—to produce a total policy fabric with the pattern, qualities, and texture most appropriate to the particular climate in which we find ourselves. We therefore turn to examine the machinery for working the threads of Bank of Canada policy into the broader policy patterns of government and for organizing the central bank to make it an effective and consistent contributor to policy as a whole.

The preamble of the Bank of Canada Act presently gives the Bank a set of general instructions to regulate credit in the best interests of the economic life of the nation and refers more specifically to the goals of external and internal price stability and to the avoidance of fluctuations in employment and production. A number of witnesses suggested that this preamble should refer specifically to the goals of full employment and economic growth. Although this might not have any practical effect on the Bank's current operations because such objectives are already kept firmly in mind, we believe it would be useful to redraft the preamble so that it more accurately reflects the full range of economic policy objectives. It might instruct the Bank to use its powers to promote the general economic and financial welfare of the nation and to contribute to the achievement of such goals as rising productivity, a high and stable level of employment, the protection of the value of the national monetary unit, the development of an efficient and flexible Canadian financial system, and the maintenance of a sound external financial position.

GOVERNMENT RESPONSIBILITY FOR MONETARY POLICY

The Bank of Canada Act is silent on the matter of government responsibility for monetary policy, partly no doubt because the Macmillan Commission—while recognizing that the state must retain ultimate sovereignty—felt it desirable that the central bank be free from the fear of interference for political ends.[1] This view of the Bank as an independent body carrying out national policy in the public interest was confirmed by the Finance Minister of the day who stressed that the Bank of Canada should not be subject to government dictation because government financing requirements might conflict with a wise monetary policy.[2] In 1936 a shift in opinion occurred, with the then Minister of Finance indicating that while the Bank should resist temporary gusts of public fancy, it must in the long run show responsiveness to public opinion and be responsible to government. However, the government was not to be concerned with daily management, but would have control through the assurance that the direction of the Bank was in

[1] Paragraphs 207 and 219 of *The Report of the Royal Commission on Banking and Currency*, 1933.

[2] House of Commons Debates, 1934 session, pages 827-8, and 840-1.

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the hands of men in whose judgment it had confidence.[3]

The emphasis was further altered by a subsequent statement of the Governor that central bank policy must conform to the policy of government, and by a 1941 statement of a different Finance Minister who, correcting an earlier denial of any ability to control Bank of Canada policy, said that the responsibility of the Governor and Board did not in any way relieve the government of the responsibility for the Bank's policy nor militate against public control of monetary policy. The Bank's monetary policy must be the government's policy although execution of that policy should be left to the management of the Bank; in the event of a dispute there could be no question that the government's view would prevail.[4] In 1951 and 1954 another Minister of Finance indicated that he shared these views and in the latter year the Governor made a further statement confirming the view that the directors and management had no excuse for not taking full responsibility for everything they did in the monetary field, but that equally there was no excuse possible for the government. The administration of the day, supported by a majority in parliament, could always change the legislation even though parliament had placed the immediate responsibility on the Bank of Canada.[5] The second Governor of the Bank confirmed this opinion in 1956, indicating that any government sufficiently displeased with the Bank or its management could bring about a change in management.[6]

The original legislation, however, had not been altered to reflect the change in views which had occurred since 1933, and in 1956 a different Minister of Finance was able to deny any government responsibility for the Bank's policy—that responsibility being placed only on the Bank—although he admitted that the government was kept informed of monetary developments.[7] This view was severely criticized in some quarters but the next Minister, too, rejected categorically any suggestion that he was responsible for monetary policy in any way,[8] and the official interpretation thus continued to be that only parliament had a direct responsibility for the Bank and that the Minister had no part in the matter. By 1961, however, events had shown that this position was unrealistic and untenable. The new Governor upon assuming office therefore issued a statement indicating that in the ordinary course of events he believed that the Bank of Canada had the responsibility for monetary policy, but that if the government disapproved of that policy it had the right and responsibility to direct the Bank as to the policy which was to be followed. This statement was accepted by the government and the current position seems to be that the Bank accepts full responsibility for its policy while the government—which is kept fully and continuously informed—does not disclaim its responsibility.[9]

The legislation, however, does not provide any means for the government to exercise its responsibility for monetary policy. The 1961 and pre-1956 statements cited above indicated that management or directors who disagreed with the government on a fundamental issue would have to resign, or implied that there were ways and means by which directors and management could be got rid of—especially if a continuing struggle should develop. In fact, however, the government has no power to dismiss directors and the Governor or to make the Bank comply with its wishes, except of course by introducing special legislation, even though it now seems to be generally accepted that ultimate responsibility for monetary policy must lie with the government and that the central bank should not be a state within a state.

There is, however, no universal agreement on what the exact relationship between the two bodies should be. It does not necessarily follow that because the Bank is a policy arm of government it should be made a department of government. Indeed most of the world's 100 central banks—

[3] House of Commons Debates, 1936 session, pages 3262-4.
[4] House of Commons Debates, 1941 session, pages 3936-7.
[5] Proceedings of the House Banking and Commerce Committee, 1954, pages 25-6.
[6] Proceedings of the House Banking and Commerce Committee, pages 348 and 373-5.
[7] House of Commons Debates, 1956 session, pages 7351-2.
[8] *Ibid.*, 1959, pp. 2050, 3098-9.
[9] Transcript, page 7454.

apart from those in totalitarian countries—are separate institutions in fact as well as in form precisely because experience has shown that the objectives of society can best be met by an arrangement which leaves some measure of independence to the monetary authority. Although it can be argued that any measure of independence, however small, is in logical conflict with the aim of bringing unity and coherence into financial policy, we do not accept this view. There is no lack of common sense in preferring some division of responsibilities to a concentration of power in one centre, provided there is a sensible means of reconciling any divergent views into a consistent whole. All policies must work to the same ultimate objectives and must be purposefully directed to those ends, but if the arrangements for designing and executing each of them were rigidly identical and did not take into account the special tasks which each must perform, we believe that the national interest would be but imperfectly served.

One of the more important operating reasons for giving the central bank a measure of freedom within government is that both residents and non-residents, particularly those engaged in financial affairs, look to an independent central bank as a guarantee that market dealings are not being undertaken for day-to-day political considerations unrelated to the broad aims of monetary and financial policy. If market values were subject to capricious influence from government efforts to gain the temporary fancy of the electorate, neither Canadians nor foreigners would be as willing to invest in this country, and the foreign exchange and domestic financial markets might become too concerned with speculating on the government's next move rather than with channelling the flow of savings into investment. The central bank also has an important responsibility to encourage the development of an efficient and flexible financial system to serve the needs of the economy as a whole as well as the special requirements of the policy makers. This function, and the closely related one of advising government on financial developments, makes it imperative that the central bank be market-oriented as well as policy-oriented if it is to be really useful. Normally some measure of independence will encourage a central bank to develop the vigour and freshness of approach, the technical competence and flexibility, and the basic understanding of market forces and attitudes needed to discharge these functions effectively. Dealing with markets, unlike many other aspects of financial policy, involves continuous decision-making and cannot be done on any sensible basis if all transactions are subject to prior approval by a responsible Minister or the cabinet. To some extent too, external financial responsibilities, especially dealings with international financial organizations and other central banks, are more easily handled if a central bank has some independence of status.

The main reason, however, for conferring some measure of autonomy on the central bank has been the historical tendency of governments of all forms to develop the habit of inflating the currency.[10] Since the process of inflation is understood by relatively few people and since it has few other organized opponents in our society, a special responsibility is imposed on the central bank to see that the objective of price stability is not forgotten by government merely because other goals have more political popularity in the short-run. While we agree with the Governor and other witnesses that protecting the value of the currency should not be an objective superior to others—although at times it deserves special emphasis—it is only realistic to recognize that government might occasionally be tempted to use the monetary system in an inappropriate way to finance its requirements through the hidden and discriminatory tax of inflation rather than through taxes which expose it to close, and possibly embarrassing, parliamentary and public scrutiny. Indeed, it was largely because the Macmillan Commission found that rates on Finance Act advances were varied mainly to meet the exigencies of government finance rather than the credit

[10] Submission of Mr. G. F. Towers, pages 10 and 11.

needs of the country that it recommended setting up an independent central bank.[11] Such independence allows the central bank to take certain steps to protect the public if the total policy climate seems more inflationary to the bank than the national interest demands, although it should be emphasized that the only real and lasting defence against inflation is the determination of government itself to resist it. A status of some freedom also makes more effective the Bank's ultimate safeguard of the public—the warning stemming from resignation of its senior management—since the departure of men of independent standing will usually attract considerable public notice and concern.

We also believe that some measure of independence strengthens the central bank when exercising its right and responsibility to try to bring about the most appropriate "mix" of government policy through private persuasion, leadership, nagging or disagreement. The increasing complexities of government policies and the growing repercussions of fiscal, debt management and international financial policies on monetary affairs make this role vital. We are convinced that the expert advice of a central bank not dominated by fears of short-run political pressure leads to more carefully considered policies than would be the case if the Bank management were only another set of departmental advisors under no obligation to resist policies with which they disagreed. Such independence must of course be reconciled with the responsibility of government to mesh together all aspects of policy, and in fact imposes on government the duty of not abdicating its functions to the Bank, particularly when they prove temporarily unpopular. If a persistent difference developed, government must have the assurance that its policy, and not the central bank's, would prevail—at least until parliament, and ultimately the public, rendered a final verdict.

There is a view that it is impossible and undesirable to tie up this awkward package of government responsibility and central bank independence with a neat legislative knot, and that it is better to leave it in the looser wrapping of common sense. No law can specify the precise ingredients which make for a working understanding in every conceivable circumstance between Governors and Ministers with different personalities and approaches to their jobs. Clearly two men of intelligence and good will can arrive at a harmony—if not necessarily an identity—of views and can make even the worst designed system function smoothly, while the best system in the world can not be made proof against folly, ill-will, or an unshakable determination to misunderstand. It is argued, therefore, that a crisis between government and central bank has a certain aura of inevitability about it and that there is no satisfactory set of rules that can prevent the development of such a crisis. On the other hand, we believe it is scarcely edifying or helpful to have an unresolved difference of opinion between the Governor and the Minister fought out in public and allowed to create awkwardness and uncertainty about the future direction of policy. Until the government has made a decision, discussions should be behind the scenes. Otherwise the result might be confusing and might distort the public debate which would be sure to take place in any event if no agreement were reached. It might also lead to hasty and ill-considered legislation which could have been avoided by creating suitable legal machinery for resolving such differences or for ensuring that the government's views on policy finally predominate. Memories are too short to leave the situation as it now stands.

We have considered a legislative framework within which the central bank would operate under a continuing directive from government. In our view such a continuing directive—suggested by a number of witnesses—would have to be either so broad as to be virtually meaningless or so narrow as to destroy the Bank's independence. Even though the Bank's views might be considered in each redrafting of this unending series of instructions, we believe this arrangement would merely maintain a misleading façade of independence and might give us the worst of both worlds.

[11] *Op. cit.*, para. 195.

We believe that central bank independence within the context of government responsibility for monetary policy can best be assured by a dual system of responsibility under which the Bank formulates monetary policy and executes it from day to day but under which the government must accept full and continuing responsibility for the policy being followed, although not in the normal course for the details of its execution. The Bank of Canada Act should be amended to make this clear and to provide the Minister of Finance with the right to issue a directive to the Bank if the government disapproves of its policy. We believe that this procedure of government direction of the Bank's policy should be used only as a last resort and after extensive and conscientious attempts to reach agreement have failed. If such a situation ever arose, its seriousness would call for highly formal procedures designed to focus full and intelligent public discussion on the matter under dispute. We therefore recommend that any directive take the form of an order-in-council to ensure that it receives cabinet consideration; that it be as specific as possible in its terms, making it clear that the government feels the Bank has been too restrictive or too expansive in its policy, pointing out in a closely-reasoned way how its actions have conflicted with national economic policies, and indicating what steps—including possibly a change in Bank Rate, market yields, or the cash reserves of the banking system—the government wishes carried out; that it be published with the briefest of delays, say within 15 days of issue; that it be accompanied by a statement from the Governor setting out his opinion of the matter; and that it should automatically lapse after 30 days so that it would not become in effect a continuing directive.

Some witnesses mentioned that these procedures might be an embarrassment to both government and central bank, but we tend to feel that they ought to be sufficiently uncomfortable to discourage their unconsidered or frequent use. Moreover, if the situation were grave enough to force resort to a directive, the public ought to know about it without delay—no matter how inconvenient that might be to the parties involved. Such provisions exist in a number of other countries, including Australia, and we were informed that their mere existence has helped to avoid difficulties that might otherwise have arisen, although so far as we are aware they have never been used. As we were told by the Governor and other witnesses, it is possible to imagine rare circumstances in which Governor and government agree to disagree in order to focus responsibility for a certain policy directly on the government. In such unusual circumstances both parties would also have to issue statements making clear the reasons for the issue of a directive; otherwise an unjustified atmosphere of crisis might be created and the independence and prestige of the Bank undermined.[12] Although we do not wish to close the door to this possibility, we think it highly unlikely that a directive would ever be used except in a situation of basic disagreement which would lead to the Governor's resignation.

We are conscious of the danger that government might get into the habit of using a directive if that power were open to it and if the sometimes convenient ability to avoid responsibility for monetary policy were denied it. Conceivably, too, the Bank could become similarly addicted to the directive in order to shift its responsibilities onto other shoulders. However, we do not believe either party would find this procedure very palatable or popular in the ordinary course of events, and we take some comfort from the fact that it has in practice never been resorted to elsewhere. In the light of recent developments in Canada and of the generally-accepted view that the ultimate responsibility for monetary policy must rest with government, we thus agree with the Governor that the existence of directive powers would not further reduce the real independence of the Bank (or the real responsibilities of government), but would merely make explicit the position now held by both parties and the vast majority of the public.[13] No legislation can, of course, guarantee the central bank its independence in perpetuity

[12] Transcript, pages 7848-50.

[13] Transcript, page 7842.

since a government with the necessary parliamentary support and determination can always change it. Nor can it guarantee the country against a government which is determined to evade its responsibility for financial policy. Good legislation can, however, serve to focus public attention if the government's role in Bank of Canada affairs tends to be either too little or too large.

No matter what the legal arrangements, it is obvious that they will be workable only if the Governor and Finance Minister keep each other fully and continuously informed on policy and the factors underlying it. Although we understand that the Governor and Minister now hold regular weekly meetings in addition to numerous more informal contacts, we believe that the legislation should explicitly impose the duty to maintain close and continuing contact and assure the Governor access to the Minister as an advisor on government financial policy. The frequency of these discussions would doubtless vary with the circumstances but, as in the United States, we think they should take place regularly and often. The existence of the directive power should not bind the Governor to consult more with the Minister than he would in any event, but it does make it desirable to give statutory effect to the present practice of obtaining the Minister's prior approval of a change in Bank Rate. Ordinary open market operations, however, require only that the Minister continue to be kept closely informed.

In view of the proposals put forward in this chapter and of our earlier recommendations on the co-ordination of government economic policy, we do not see any need to establish yet another committee to co-ordinate the roles of the Bank of Canada and Department of Finance. The Deputy-Minister of Finance is after all an ex-officio member of the Bank's Board and Executive Committee—an arrangement which we believe is satisfactory and which calls for no special comment—and by virtue of his frequent formal and informal contacts with the Governor is in an excellent position to provide the Minister with another closely-informed view of the Bank's policy and activities.

We have argued that the independence of the central bank is meaningful and necessary for its dealings with financial markets and the public, both at home and abroad; for the force and relative detachment with which it can give advice to government; and for its ability to warn the nation if any government were tempted to tamper with the currency. This independence, however, does not give it the right to enjoy sovereign power—it imposes the duty to act in the public interest. It has content only if the Bank's management has enough wisdom and good sense to find workable compromises where disagreements are not over central issues, and enough courage and integrity to stand firm if it truly believes the national interest is being endangered. A good Governor will never do anything to which he is fundamentally opposed but he will not feel it necessary to oppose automatically all ideas originating outside the Bank. In the last analysis, however, if he sincerely believes government policy makes it impossible for him to discharge his job as monetary manager he must be prepared in good conscience to resign.

We have also stressed that the government must share responsibility for monetary policy and must have the means to ensure—in the event of conflict—that its views prevail. While we hope the Minister would normally leave monetary policy in the Bank's hands and would shield it from short-run political pressures, we realize this will not be easy—it was after all an opposition question about raising the Bank rate to the "unprecedented high level of 3¼%" which led a former Minister to deny responsibility in 1956.[14] However, we can only hope that, as in other countries, the somewhat awkward and embarrassing procedure which we have favoured will strengthen the resolve of future Ministers to defend the monetary authority against unjustified attack and encourage them to acknowledge their own responsibility for prevailing credit conditions, if only because they have not chosen to object to them.

[14] The question went on to refer to "spectacular increases" from 1½% and to their "very dangerous and unsettling effect". House of Commons Debates, 1956 session, page 7351.

In a well-functioning democracy, responsibility for monetary policy, while dual in nature, must be clear and unmistakable. There should be no possibility of Bank and government hiding behind each other's back by claiming that they were forced to act against their wishes. Our political system obviously requires government to respond to the preferences of the public, but it is equally clear that it must not do so in surreptitious, ill-conceived, or hasty ways which sacrifice the longer-term public interest to short-term political pressures. Accordingly, we have suggested a mechanism which allows the government to take direct responsibility for monetary policy if it believes the national interest requires it—but in a way which should reduce the possibility of concealed domination of the central bank, encourage full consideration of all the implications of its action, and lead to that full and informed public debate which is an essential part of a truly responsible democracy.

RESPONSIBILITIES OF THE BANK'S DIRECTORS

The responsibilities of the directors of the Bank of Canada are not very different in form from those of other corporate directors. The Act states that the Bank shall be under the management of the Board but provides that the Governor, as chief executive officer, has the direction and control of its business on the Board's behalf and may act on all matters not specifically reserved to the Board or Executive Committee. However, the substance of their responsibilities is of necessity different from that of most other directorates in view of the technical complexity of many aspects of Bank of Canada policy operations, the government's ownership of the institution, and the need for closely co-ordinating all aspects of government policy.

Nevertheless, we believe outside directors can and should play an important and active part in the affairs of the Bank, not least in ensuring that its business and administrative procedures are sensible and efficient, expenses are well-controlled, real estate is properly managed, and that the Bank stays within its legal powers. These "housekeeping" functions are particularly important in a central bank since its expenses are small relative to its revenues and it is easy to slip into inefficiency. A more important function of the directors, however, is that of appointing staff, seeing that salaries are reasonable, ensuring that the proper personnel is recruited and adequately trained, and judging management's performance—particularly in the higher ranks. The job of selecting top management puts a special responsibility on the Board to make certain that a number of suitable candidates are always available within the Bank—even though there may be some senior appointments from outside.

We received views that the Board's role should be confined essentially to these functions and to a minor advisory status on broader Bank policy. However, we do not believe that the government is likely to be able to recruit men of the judgment necessary to perform even these limited tasks if they are to be only glorified management consultants who learn of policy always after the event and who—while useful for window-dressing—can be freely ignored for other purposes. As was emphasized to us, the basic responsibility of the directors is a heavy one—and could extend to informing the Minister that management was not equal to its work.[15] It also involves a broad appreciation of monetary policies and their part in national economic policy. For these reasons, the Board must be composed of men of first-rate ability and a strong sense of public service.

The Board's duties also include supplying management with business information and with first-hand impressions of business and public reactions to the developing economic scene and the Bank's policies. Although these duties may be less important than they used to be because of improved public communications and the development of new statistical and other sources of information, we have the impression that the Board could well do more than it now does in this field. Board members—like the Governors of the Federal Reserve System—should also play

[15] Submission of Mr. G. F. Towers, page 2.

an active role in explaining the Bank's policy to the community, although we recognize that the difference in the two systems will not allow them to fulfill this function with quite the vigorous independence of their American counterparts.

In our view, however, the most important of the Board's functions is to accept collectively the final responsibility for the management and policies of the Bank—subject to the Minister's right of directive. This responsibility must take many forms and includes: reviewing the actions and proposals of management to ensure that they are sensible; putting forward suggestions, ensuring that different opinions within the Bank are considered, and preventing the domination of policy by the wrong-headed views of any one man or group of men; and—most important—giving support and encouragement to the Governor, if necessary by being prepared to resign with him to defend policies which the Board believes to be right. As with any good board, the directors must and do rely heavily on the full-time management to take the initiative in putting forward policy recommendations and must give the officers a free hand to implement these measures—subject to subsequent Board review. If, however, the Board were to lose confidence in the senior officers of the Bank, it would clearly have to watch developments more carefully and keep the Minister closely informed. In normal circumstances, the Board would have sufficient control of the Bank's affairs merely through management knowing that it would shortly have to explain and justify its actions to the directors. No doubt occasional lively debates would take place, as happens for example in Australia and the United States, but we hope that the Board would not consider it part of its function to be continually second-guessing the management.

While we recognize that the Governor now takes pains to know the general thinking of the directors, to explain and justify his actions in a broad way, and to indicate the nature of the policies which may be appropriate for the immediate future,[16] we nevertheless have the impression that the Board might be somewhat more closely consulted on Bank policy. For example, special meetings might be held to discuss unusual problems and, if this were not possible, the Board ought to be at least informed and consulted about major policy or other changes by telephone. We also urge the Governor, whose close and continuing relations with the Minister make him much more familiar than the outside Board members with government policy, to make every effort to take the directors fully into his confidence. We realize that at times—for example when the budget is being prepared—he will have confidential information about government policy, but there is a tendency for secrecy to be overdone in Ottawa. The Minister should whenever possible encourage the Governor to discuss with his Board—if only in the most general way—matters of government policy relevant to their decisions. We have been told of the discouragement which Bank directors feel when asked to put a rubber stamp on accomplished facts.

Canada's geography does not allow the directors to meet as frequently or easily as the Court of the Bank of England, but we believe they ought to meet more often than the present seven or eight times a year, although perhaps not as frequently as the Federal Reserve Open Market Committee which assembles every three weeks. We therefore recommend that the Board be required to meet not less frequently than 10 times a year and more often if circumstances make it necessary. To this end we suggest also that the present $30,000 annual limit on aggregate directors' fees, which acts to limit the number of meetings, should be raised in order to allow the directors' fees to be made more comparable to those of the chartered banks. We further recommend that the Executive Committee—which meets weekly and has the powers of the Board between meetings—should be enlarged by adding one, or preferably two, outside directors to the present membership of the Governor, senior Deputy Governor, Deputy Minister of Finance and one outside director (a second

[16] Transcript, pages 7801-2.

outside director who is a member of the Executive Committee of the Industrial Development Bank[17] often attends these meetings as well). The role of the Executive Committee is a vital one because of its frequent meetings and close contact with policy, both past and prospective, and we believe more of the outside directors should now participate on it, especially since improved travel facilities make it less difficult than formerly for them to do so.

These proposals, while strengthening the independence of the Bank within the framework of government, are not likely to increase the remote possibility of conflict between the Board and the Governor or between the Board and the Minister of Finance. A good Governor will be the leader of the Board and if he develops sound working relations with the directors he is not likely to run into an unsupported conflict with the political authorities. In any event, it is one of the Board's functions to detect early any tendency for the Governor to fail to discharge his duties effectively and to take steps to bring the situation under control. In this connection we believe that if the Board should ever lose confidence in the Governor the Act should require the directors to inform the Minister of Finance of their view, preferably in writing. If such disagreements arise between Governor and Board, the government, as sole shareholder and ultimate controller of the Bank's affairs, must be the final arbiter. If the Minister and cabinet agreed with the Board's view, any further steps would have to be taken by the government. If, on the other hand, the government disagreed with the directors, the Board would presumably resign. However, an informed and intelligent group of directors is far more likely to be a source of support to a competent Governor than a centre of opposition to him. No government is likely to regard lightly the threat of wholesale resignations from a Board representing a cross-section of national opinion, especially if it arose from unjustified interference with the Bank, and —as we were told had happened elsewhere— would probably drop any unreasonable demands or seek a sensible compromise.

[17] This might not be the case in future if our recommendation about creating a separate board for the I.D.B. is adopted. See Chapter 12.

COMPOSITION AND QUALIFICATIONS OF THE BOARD

Our predecessors on the Macmillan Commission recommended that Board members be men of "experience, skill, and integrity",[18] but the legislation states only that directors must be Canadian citizens from outside the federal or provincial public services who are not over 75 and "selected from diversified occupations". Appointments have in practice been regional, with one representative coming from each province except Ontario and Quebec, which have two; the Governor, senior Deputy Governor, and Deputy Minister of Finance complete the Board, which is appointed by the Minister of Finance with cabinet approval. We received many submissions stressing the importance of the quality of the Board, and some proposals for changing the present Act. However, no law can guarantee that governments will make appointments with wisdom and good sense and our first and most important recommendation is thus to urge government in the strongest terms to fill Board vacancies only with men of the very highest qualifications.

In terms of efficiency and the directors' sense of participation in Bank affairs, the Board might well be smaller, and less weighted by geography, than it now is. We believe that a satisfactory regional representation and a useful diversity of occupations could be realized if, say, five outside directors were appointed with such factors in mind and three others were appointed exclusively for their intrinsic qualifications or financial expertise. Even if it is not practical to reduce the Board's size, it should, nevertheless, have a very substantial nucleus of men with particularly relevant qualifications and experience. We do not favour adding to the Board's numbers since this might seriously reduce its usefulness and would not make it any easier to select suitable candi-

[18] *Op. cit.*, para. 227.

dates. Our views on the size and regional composition of the Board are related to our later suggestion that regional advisory committees might be established, but whether or not this approach is followed, we wish to recommend that the term of Board appointments be extended to five years; the present three year period seems unnecessarily short in view of the time required to become familiar with the responsibilities. The law should also provide that appointments be on a staggered basis (with provisions for interim appointments to complete unexpired terms) in order to assure maximum continuity and to eliminate the possibility of wholesale changes when new governments took office.

We considered a proposal that the Board itself have the right to appoint one-third of its members, subject to approval by the Minister of Finance. However, this seemed to lead to unjustifiable complexities, particularly since we were told that the Federal Reserve's own appointments to regional Bank boards were not very different in calibre from the nominations of other groups. While it might not be appropriate in our different circumstances to imitate the Bank of England practice under which the Bank itself plays a significant role in choosing members of its Court—although they are formally nominated by the Chancellor—we do feel that the government and Bank could profitably emulate the United Kingdom tradition of doing an extensive "scouting" job for Board prospects. We understand that the Governor, and other independent sources as well, are now sometimes consulted in an informal way on appointments to the Board of the Bank of Canada. It would be useful if this process were extended to give more weight to the opinions of the management and directors of the Bank.

On a more technical point, we wish to recommend the removal of the prohibition on Bank directors holding shares in chartered banks set out in Section 10 (1) of the Act. Relatively minor shareholdings in any financial institution are unlikely to influence the conduct of men of integrity and independence, and the present divestiture requirements are an unnecessary irritation. We believe the public interest would be adequately safeguarded by an amendment providing that directors should disclose their holdings in all banking or financial institutions to the Minister of Finance. Directors should also be required to advise him promptly of any changes.

However helpful these legislative changes, it is on the calibre of appointments that the quality of the Board ultimately depends. This does not mean that the only qualifications for Board appointments should be expertise in financial markets or economics. We agree with our central banking witnesses from at home and abroad that the collective wisdom and standing of the Board would be weakened if it were composed only of financial and economic experts. There is after all a great deal of expertise within the Bank itself, and the primary qualities of good Board members should be intelligence, wisdom, and good judgment. We believe these can best be found by choosing highly-qualified men from varied backgrounds and experience, although we explicitly reject the view put to us on several occasions that these men should be appointed to represent the interests of particular bodies such as provincial governments, chambers of commerce, associations of professional economists, or trade unions. Board members should serve only the public interest —they should not be instructed delegates of special interests. Although men with backgrounds in economics, government service, or the labour movement could bring valuable understanding and experience to the Board of the Bank, we do not feel that there should be any rigidity—statutory or otherwise—in the composition of the Board; the only prescription is that it be filled with the best talent available. Clearly it is desirable that some of the Board members be men with economic and financial backgrounds who can supplement the expertise and experience of the Bank management in these fields, and bring informed opinions to the vital task of judging management. Although there are now men on the Board with considerable financial experience—including a retired bank president, directors of

life insurance and trust companies, and directors of a provincial savings bank and a municipal finance corporation—it would be constructive to add one or two more members with suitable qualifications in the field of economics and finance.

We are, however, firmly of the opinion that it would be unsuitable to appoint to the Board any officer, director, or employee of security firms and banking institutions. We recommend, therefore, that Section 10 (1) of the Act, which refers only to the chartered banks in this connection, be amended accordingly. This is in fact the position in most central banks although the Bank of England has a director from one of the smaller banks on its Court, and some members of the boards of Federal Reserve Banks—which do not participate in the System's policy-making—are from the field of banking and finance. It was also admitted to us quite freely that in Canada a banker could not serve on the Board without a conflict of interest and the appearance of gaining some advantage over his competitors.[19] Honest men will naturally try not to be influenced by the conflicting interests which are encountered in life everywhere, but developments in other countries have convinced us that no central bank board which is closely involved in policy should even give rise to any suspicions of such conflicts—however unfounded—that might reflect on the good name and standing of the institution itself. To this end, we recommend that appointees to the Board should divorce themselves from those aspects of their firm's activities which could be immediately affected by decisions of the central bank so that their actions, or lack of them, will not encourage speculation that something is afoot in the Bank of Canada. The Board might wish to pass a by-law to formalize this practice. We also think it would be good practice for members leaving the Bank board to allow some time to elapse before assuming private directorships in institutions with which the Bank has direct dealings.

It might be found desirable to supplement the role of the Board by establishing a number of regional committees—e.g. in the Atlantic Provinces, Quebec, Ontario, the Prairies, and the Pacific region. Such committees might help to increase the Bank's knowledge of general developments and public reactions in different parts of the economy, would encourage senior officers of the Bank to get out of Ottawa more frequently, and could assist in the creation of an informed public opinion on monetary matters. These committees might consist of six to eight men appointed by the Board and drawn from a cross-section of informed people familiar with the region concerned, including bankers and security dealers. They might meet twice a year in different centres within the region under the chairmanship of a Bank director and, after a brief introductory review by a senior officer of the Bank, have an extensive discussion of economic, financial, and monetary developments in Canada.

INTERNAL MANAGEMENT OF THE BANK

In view of our earlier proposals, we are not suggesting any change in the present provisions which make the Governor, or in his absence the Deputy Governor, responsible for the daily management of the Bank between Executive Committee and Board meetings. While management by a committee of officers, as in the United States, has the advantage of limiting the power of any one individual to implement ill-conceived decisions, it has the disadvantages of lessened flexibility and sensitivity and it, too, depends on effective leadership from the chief executive officer. Such a system would represent a radical departure from that which has developed in Canada and on balance we do not believe that it would be a desirable innovation. With a strong Board and Executive Committee, the danger of major and sustained errors of judgment should be much reduced. If in addition the senior staff is strengthened from time to time by the appointment of an experienced member of the financial or academic community, we believe that the Canadian central bank can be well adapted to meet the growing and increasingly complex demands upon it. In other words, we would not wish to

[19] Transcript, pages 8308-9.

divide or lessen the responsibility of the Governor, but we believe it of the utmost importance that he should have the best available advice. The responsibility for decisions must remain his, but like any good manager he must make sure that all aspects of these decisions are carefully considered before they are executed: indeed, the Governor stressed that he is careful and anxious to get all the help and advice that he can from his staff, and has continued his predecessor's practice of meeting with the senior personnel of the Bank each morning to review financial happenings, economic information, new government policy positions, and general international developments.[20]

We received a number of representations that the central bank has become ingrown and out of touch with financial markets and that more persons with substantial outside experience should be appointed to its senior staff. In particular, it was proposed that law or custom require one of the Deputy Governors to be brought in from a private financial institution for a specific tour of duty with the Bank.

Lying behind these suggestions is the contrast between the present position and the Bank's formative years. Many of the first top officers of the Bank had come to it with experience in senior positions in banks and investment firms. While central banking experience was lacking, this was borrowed from the Bank of England in the person of the first Deputy Governor. A generation later, the most lively concern is not a shortage of monetary skills, but the need for the Bank to keep in touch with and understand financial markets, banking institutions, and the people who run them. The deficiencies of the Bank in this respect are difficult to determine, but they are quite widely felt and we believe there is a real problem to be met. The Bank itself appears to be aware of it as some of its recent actions and appointments suggest.

We think some suitable senior appointments from outside can be helpful, and we hope the Bank will be alert to such possibilities. Admittedly, there are real difficulties. We were told by our central banking witnesses of the universal difficulty of recruiting outside personnel at senior levels, in part because central banking has become a unique profession requiring special skills and attitudes and in part because of the inability of central banks to match the material rewards offered elsewhere. We would agree that limited tours of duty at the Bank by senior outsiders would encounter formidable obstacles, including conflicts of interest, the difficulty of becoming thoroughly conversant with basic central banking problems in a short span of time, and interruption of a career. While we would not wish to rule out this possibility, it is more feasible to contemplate making the occasional permanent appointment of an experienced outsider at a senior level. We feel that the addition of an able investment dealer, academic economist or banker to the top management of the Bank can contribute to mutual understanding between the Bank and the outside community. As to the problem of offering sufficient inducement, this emphasizes the need for an adequate scale of remuneration at the Bank, although because of its proximity to the civil service, salaries in the central bank will never be competitive with those available to able men in private occupations. The importance of the work, reasonable status, an interest in public service, and other non-financial inducements are, however, important, and in this connection we think the Bank might be better able to attract qualified outside personnel by the appointment of additional Deputy Governors. While the number of senior posts which can be filled in this way is small, we do not see any difficulty about one or two additional appointments (at present there are three Deputy Governors), particularly if they helped at the same time to bring some new experience into the Bank's counsels. A further useful step might be to appoint more than one of the Deputy Governors to the Board of the Bank, although we would not wish to see it dominated by "inside" directors.

We believe that the present method of appointment of the Governor and senior Deputy Governor is sound. Appointment by the directors

[20] Transcript, pages 7818-9.

ensures that an outside non-political view is brought to this important task, while the need for cabinet approval allows government in effect to veto any nomination unsatisfactory to it; presumably the Board would resign if its members believed the government were not anxious to see good men hold either office. Other appointments are made by the Board itself, but as with the top two posts, the presence of the Deputy Minister of Finance on the Board ensures that any suitable suggestions from government are considered. The Governor's present seven-year tenure of office seems adequate to safeguard his independent status; shortening the term would only mean he spent a higher proportion of it learning the job. Nor do we believe the appointment should lapse automatically when a new government takes office since this could relate the job too clearly to the political party in power; a directive procedure would also make such an arrangement unnecessary. We are satisfied with the provision that he hold office during good behaviour, apart from voluntary resignation for personal or policy reasons. This provision means that the Governor (and Deputy Governor) can be removed only by special legislation or a joint address of both houses of parliament. This is admittedly a somewhat cumbersome and embarrassing procedure but there is no reason why it should be easy for a government to get rid of its central bankers without valid cause. We take it that any Governor who found himself in clear and basic disagreement with the views of the Government would resign, whether or not a directive were actually used.

We did not consider in detail the salary and pension arrangements of the Governor and Deputy Governor, but we believe that their compensation should reflect their special and heavy responsibilities and the problem of obtaining senior persons from outside. Considerable private means or willingness to make personal sacrifices should not be a requirement for these posts, the salaries of which, as noted earlier, are below comparable positions in the private sector. We would also like to record our view that pension arrangements be sufficiently generous so that no Governor has to be unduly concerned about his family's security in deciding to resign on a question of principle, particularly since he is not easily able to take a suitable job in private industry immediately. The present pension arrangement for the Governor appears to meet these tests. The Bank's Board has power to set the Governor's salary subject to cabinet approval and, to avoid future controversy, we recommend that pension entitlements also be put on this basis.

Another aspect of the Governor's status which we considered is his power to veto decisions of the Board, subject to informing the Minister in writing of the circumstances within seven days. Any director or member of the Executive Committee is also entitled to inform the Minister in writing of his view of the matter. This correspondence must be transmitted to the cabinet, which may then confirm or disallow the veto. The provision was originally put in the Act when directors were elected by private shareholders and is now an anachronism. If Governor and Board should ever have a falling out, the Minister of Finance will learn about it through the channels discussed earlier and can take the steps necessary in the circumstances. Since the veto power would be redundant under any directive system and since it may at times inhibit Board discussion, we recommend its abolition.

We believed our terms of reference did not require us to conduct a detailed examination of the internal organization of the Bank of Canada and we did not do so. Our impression is that its affairs are administered efficiently and effectively. Most of the 840 people on the Bank staff are in fact engaged in routine operations—handling currency and the public debt, internal audit, administration, and the processing of regular statistical series; the key central banking functions are performed by a comparatively small group. About ten people attend the daily meeting with the Governor, although they in turn may have sought opinions from as many more.[21]

[21] The personnel of the securities, research and foreign exchange departments combined number about 60—excluding library and clerical staff.

Some of the staff members not engaged in routine operations are by qualification and preference best suited to the performance of one job, but we believe that many of them, including the small minority who will ultimately form the top management, could profit from more interchange between departments of the Bank. While we recognize the extent to which a varied training can be gained within the different sections of a single department, particularly on the research side, we were struck by the extent to which the Federal Reserve Bank of New York moves its people around from one department to another and by the apparently excellent results of this program. We believe the Bank of Canada might find it useful to expand its own program of moving key personnel to other departments so that, for example, research officers get a practical working knowledge of financial and foreign exchange markets, and securities personnel improve their understanding of the basic economic and monetary forces which underlie day-to-day market movements. Thus a research man who reached a top post in the Bank might have had two tours of duty on the securities side—in a junior and in a more responsible position—as well as a period in the foreign exchange department. This program might widen the possible routes of staff advancement and increase the number of potential top managers in addition to improving the Bank's internal communications, co-ordination, and knowledge.

Within the staff, too, continuous efforts should be made to prevent the Bank from becoming inward-looking. Personnel at all except routine levels might be encouraged to acquire more trading and general financial experience and exposure to "outside" attitudes by the arrangement of temporary interchanges with banks and investment houses. Moreover, the management of the Bank ought to be prepared to see a certain amount of turnover of personnel, especially since an outward movement of staff can lead to a more informed financial and academic community. We would not wish to see these movements in and out of the staff pushed to the point where there is no permanent and satisfying career open to central bank staff with high potential, but it must be recognized that central bankers, no matter how recruited, will quickly become inbred if efforts are not made to foster contacts with the outside world and to bring them into continuous touch with markets, financial institutions, and the community generally.

PUBLIC RELATIONS AND CONTACTS

We received a suggestion that the central bank should undertake more exchanges of personnel with the universities: the Bank now brings university faculty members in to work on summer projects and recently arranged for a university professor to work with it for a year. We hope it would be found worthwhile to expand these activities, which we were told have yielded fruitful results in the United States. We would not even wish to rule out the possibility that the Bank might create occasional fellowships to encourage studies of financial markets and policy of value to the Bank. This might be part of a program of more fundamental research which the Bank management may well find it worthwhile to institute, even though most of its research must continue to be of an operational kind. We were told by the Governor, for example, that the Bank may do more econometric and other work on monetary policy's impact on spending decisions, a project which our own experience suggests would prove interesting and helpful. We hope also that the Bank will not hesitate to publish more of its own research and statistical work as part of a continuing program designed to improve Canadian monetary and financial information. In some respects, the amount of information and statistics available from our central bank lags behind the United States, although in others —particularly in the money market area—information is more completely and quickly compiled than anywhere else in the world. As part of this broad education program, the Bank might also consider organizing informal meetings with economists from universities, governments, labour and business to exchange ideas, information, and opinions about monetary and financial developments.

The central bank has sometimes been criticized for being too like an "ivory tower". Indeed, it needs the broad view and atmosphere of detached reflection of an ivory tower, but it also needs to be equipped with a good usable—and well used —door, a welcome mat, and plenty of windows on the world. While the Bank of Canada has always been aware of the need for good contacts with the financial institutions and markets, there have been occasions when these relations have been given a rather low priority. At times intentions may be good but both sides are too busy to arrange a meeting; at other times an air of mutual distrust appears to divide the Bank and the private sector. On occasion, too, the private institutions have gone to these meetings ill-prepared, with the result not only that relatively little was accomplished but that resentment accumulated at the way the Bank was able to dominate the meeting. Our only suggestion is that both the Bank and the private institutions continue to increase their efforts to make franker and more frequent contacts with each other, although the usefulness of such discussions will also depend on the willingness of each side to listen to and try to understand the other, and on a readiness to prepare seriously for them. However, it must be realized that the central bank will never be in a position to be completely open about future policy, although there is no need for it to carry secrecy to excessive lengths.

In some respects the contacts of the Bank with the financial institutions and markets appear to be extensive and improving, for example in the banking field where quarterly meetings are held with the general managers, other meetings occur with the presidents, and more informal contacts are made at other levels. These discussions result in an exchange of information and views on the broader economic outlook and on banking developments and financial trends generally. With the investment community, too, there is a fair amount of what the Governor called "to-ing and fro-ing" as well as the occasional more formal meeting with the money market dealers, but it was suggested by the industry that there is a need for a formal advisory committee. However, the difficulties of selecting members for such a committee, the conflicts of interest entailed, and the responsibility of the government and Bank for financial policy do not suggest that such a committee would be useful—indeed it might become too ritualistic and unreal. Nevertheless, the Bank might still try to meet regularly with associations representing the investment dealers and stock exchanges. The Bank has recently agreed to maintain regular contact with the association of trust companies and its principal individual members; it might also institute similar meetings with the different bodies representing the credit unions, small loan, instalment finance, and life insurance companies, all of whom expressed a desire for some such regular and informal contacts.

As in England and the United States, these contacts would be essentially for the purpose of encouraging mutual understanding and, to a lesser extent, for the exchange of information and ideas. We do not believe such meetings should lead to the giving of formal advice by either side; the Board of the Bank should be the formal outside advisor to the management, although of course the latter should consider all the worthwhile ideas put forward from any source. Nor should the Bank ordinarily use these contacts to influence the behaviour of the various institutions concerned and to substitute its judgment for that of the market. However, there may be times when the Bank because of its special knowledge can point out the consequences and dangers of certain types of activity and the desirability of others, but this should be done only rarely and in unusual circumstances. We pointed out in Chapter 22 that we do not believe the Bank should be given powers to impose selective controls on financial institutions, although it may wish to reach temporary agreements with them in unusual circumstances. As we stressed there, such agreements should have the express approval of the Minister and should as a general rule be publicized promptly.

Although these proposals are designed to make the Bank's market contacts broader and less olympian and although we are very much aware that the making of monetary policy—while a government function—should not take place in seclusion with only statistics and computers for companions,[22] we are anxious at the same time to avoid seeing the central bank become a captive of the market with its somewhat different, and often narrower and more short-run, viewpoint. We found it difficult, therefore, to judge the wider validity of the representations already noted in Chapter 16 that the Bank's trading procedures, while on the whole good, could be improved. The main claim seems to be that more trading personnel with greater trading authority are needed in Toronto and Montreal in order to reduce occasional delays and eliminate certain operating practices which upset the market and reduce the effectiveness of the Bank's operations. The Bank trading operation, although very busy at peak periods, does not appear seriously understaffed. Nevertheless we have the impression that market contacts could be improved if more trading discretion were at times given to the Bank's Toronto and Montreal representatives and if they were informed more closely about the objectives they were to pursue.

Market relationships might also be improved if the Bank discontinued its present time-consuming practice of only responding to bids and offers from the market. At times it may need to have a precise list of posted prices, and if so it can safely make them known; if on the other hand it is trying to encourage the market to find its own level in a self-reliant way, there is no reason why it couldn't immediately tell an enquirer whether or not it was in the market and at which level, even if, like the Federal Reserve System, it was not active in many issues or was maintaining prices outside the range at which private trading was taking place. We are sure the result would be improved confidence and understanding.

One proposal put to us was that the Bank centralize all open market operations in one of the main financial centres, a parallel to the New York activities of the Federal Reserve System which result in excellent market contacts and imaginative execution and policy techniques. However, partly as a result of this arrangement, there is only one money market centre in the United States, whereas in Canada about 60% of the transactions take place in Toronto and most of the balance in Montreal. Clearly it would make little sense to have all Bank operations directed by two senior officials in two different centres outside Ottawa, and even less to force them into one. Moreover, conducting operations virtually independently of Ottawa would cause problems of communication to occur within the Bank rather than between the Bank and the market. The Federal Reserve System, despite the broad authority delegated to the account manager, has to devote much effort and extensive resources to maintaining communications between Washington and New York, and even then is not always successful.

While the central bank in Australia has continued to be based in Sydney with a large office in Melbourne even after the capital was moved to Canberra, we do not regard it as practical or desirable to consider the radical step of moving the Bank of Canada's head office to one of the main financial centres. Quite apart from the difficulty of choosing its new location, the problem of bringing about improved relations with the financial community is neither so serious nor so incapable of remedy in other ways as to justify such a drastic upheaval. More important, however, the central bank is an advisor and an arm of government and we believe it would seriously impair its effective working relationships with the federal authorities if it were to be removed from Ottawa.

An opposite proposal is that all market operations be centralized in Ottawa. Although there would be no technical communication problems in doing this, we feel there would be a serious loss of that market understanding which comes not just from frequent personal contacts but from living in the climate of an active market centre.

[22] Submission of Mr. Allan Sproul, page 19.

The Bank must be a market institution as well as a policy-making one, and we believe that moving all the trading to Ottawa would result in some loss of imagination and effectiveness in the execution of policy.

We were thus led to the conclusion, reinforced by the views we expressed earlier about exchanging staff within departments of the Bank, that the directors should consider the possibility of changing the functions and qualifications required of those who in future serve as the Bank's agents in Toronto and Montreal. These men might be in overall charge of the trading operations at these centres and be advisors on market policy, would be responsible with administrative assistance for handling the entire business of the agency, and—as in New York—could be given a small staff to work on more market-oriented research and current financial statistics. Like officials in New York, they might set aside at least half an hour every day during which two or three of the main market dealers in rotation could come in to discuss technical problems or policy matters of mutual interest. While these arrangements should not preclude members of the financial community visiting Ottawa, they might be expected to raise most points with the Toronto or Montreal agents first. As now, the Governor and other senior officers from Ottawa should continue to visit the principal financial and other centres but the agents—who might ultimately be given the rank of Deputy Governor—would relieve them of some of the increasingly numerous more routine contacts which a growing financial system makes necessary. Obviously the agents and Ottawa would have to keep in close touch to ensure that policy was being effectively co-ordinated and executed and that the views of Bank and market were being made known to each other. We believe this arrangement—while admittedly more difficult to administer than the present one—would adapt easily to changes in the structure of Canada's financial markets and would accomplish the dual objectives of improving the training of senior management and of increasing mutual understanding between the central bank and the financial community; these in turn would help to achieve the broader objective of increasing the effectiveness of monetary policy.

We have already made a number of suggestions designed to improve the general public's understanding of monetary policy and to continue dismantling the barricades of secrecy still surrounding central banking. Mystery leads to misinformation, and monetary policy needs informed public opinion to function effectively and acceptably. As the Governor pointed out, much of this information must be backward-looking, but we believe it need not all be. The Bank's annual report provides an excellent background for public discussion, and we would hope that whenever conditions are appropriate the Governor and his senior staff will not hesitate to make public speeches dealing with Bank policy and its role within the framework of government policy. Although it should by now be well-established that any controversial public discussion by Bank officials of other aspects of government policy can only take place if acceptable to the Minister (unless a directive procedure were invoked), we firmly believe that the central bank must take the lead in providing the public with ideas as well as data if it is to stimulate intelligent and informed analysis and debate about financial policy generally.

We noted earlier the importance of top level contacts between the Bank and the Department of Finance, but would like to emphasize here the need for the Bank staff at all levels to keep in close and frequent touch with their opposite numbers in Finance and other departments. We believe there have been times when working contacts were not frequent or extensive enough, and certainly less than in the United States. There may always be a certain amount of healthy professional rivalry between departmental and Bank officials, but this should not be allowed to impair relations between them. The Bank's greater independence in recruiting staff and its greater flexibility in promoting them may also cause some resentment in Ottawa, even though Bank salaries below the very top level are com-

parable to those paid for equivalent responsibilities in the public service. In any event, as we argued in Chapter 25, the best way to deal with this problem is to give more freedom to the Finance Department to hire and promote talented personnel at salaries in line with the heavy responsibilities that they must bear.

OTHER LEGISLATIVE RECOMMENDATIONS

There are a number of points in the Bank of Canada Act which call for amendment besides those noted earlier in this chapter. For example, Sections 22 and 23, which provide for the redemption of Bank of Canada notes in gold and the maintenance of a gold ratio, have both been suspended for many years and should be removed from the Act. The basic integrity of our currency does not depend on gold but on the skill and wisdom with which it is managed: the world no longer depends only on gold for its international reserves—holdings of other currencies may be a more important measure of our international position, but no precise ratio of these reserves to our liabilities or to any other measure can or should be spelled out in legislation. Although we recommended that our exchange reserves continue to be held by the Minister of Finance to eliminate any unnecessary monetary complications from changes in them, the Bank should continue to operate as agent for the Minister in this field and should retain power to deal in foreign exchange on its own account. This is particularly important in view of the gradual expansion and development of the international currency operations of central banks designed to strengthen the world payments system.

While we received no representations that the list of instruments in which the Bank of Canada has power to deal is either inadequate or excessive, we see no reason why this list—already extremely broad—should not be removed entirely from the Act and replaced by a provision which entitles the Bank to deal in any securities, take or pay interest on any deposits, and make any loans which the directors may deem necessary, provided that it engage in no such transactions for purely commercial reasons. This would ensure flexibility to meet any contingencies which could not be handled under the present provisions and would make it unnecessary to change the Act specifically to give the Bank powers to take deposits from, and make advances to, the various classes of institutions which we recommended in Chapter 19 should hold their cash reserves with the Bank.[23] It would also make it unnecessary to insert a special provision giving the Bank the ability to pay interest on international deposits should this prove necessary.[24]

The Bank clearly should continue to act as the fiscal agent for the federal government in view of its special market expertise and of the need to harmonize debt management and monetary policy. However, the same section of the Act enables the Bank to act as banker or fiscal agent to the government of any province by agreement. While never used in practice, we believe it should be removed since the Bank could not run an effective national monetary policy if it were to be continually under the obligation to put out new issues for the provinces, at least without conflicting with its fiscal responsibilities to its provincial clients. Adequate fiscal and banking advice is available elsewhere, and the embarrassment which would result from the central bank vetoing an unsound provincial financial program rises all too readily to the imagination.

We also believe that the real estate provisions of the Act should be amended to make clear the Bank's right to acquire real estate to the extent necessary to meet its present requirements and

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[23] It hardly seems necessary to retain Section 71(3) of the Bank Act which extends a government guarantee to chartered bank deposits at the Bank of Canada if "the property and assets of the Bank of Canada are insufficient to pay its debts and liabilities and if the Bank of Canada suspends payment of its liabilities".

[24] At present, the Bank meets this problem by earmarking the interest on certain securities for the account of the international body concerned.

reasonable future needs. We received representations that the Bank was acting beyond its powers in planning a building in Vancouver, although the Bank's counsel is of the opinion that this was not the case. In any event, the Bank's powers in this field should be clearly stated and should in our view not leave any room for doubt about the Bank's ability to rent to others space not immediately required.

We have no special recommendations to make regarding the present audit requirements, which provide for the appointment of two outside auditors from a suitable panel. However, we suggest that schedules be appended to the Act which would oblige the Bank to show in fair detail the sources of its revenue, the classifications of its expenditures, the numbers and functions of its staff, and other relevant information; a worthwhile start has been made in recent annual reports. This report must be tabled in Parliament within a limited time after the fiscal year-end, a provision which seems suitable and satisfactory. Normally the Minister of Finance might be expected to answer parliamentary queries about monetary policy, whether or not they arise from the annual report, since he has political responsibility for Bank of Canada operations. However, direct questioning of the Bank management by parliamentary committees could be quite appropriate in special circumstances, for example when the Act is under revision or if a directive has been invoked.

CONCLUSION

In making recommendations, our over-riding aim has been to ensure that the status and organization of the Bank of Canada enhance the effectiveness of monetary measures. We are convinced that this can best be achieved under a system in which the responsibilities of all concerned are sharp and real. Our proposals offer no excuses to government for failing to harmonize monetary policy with other measures or to the Bank management and Board for not taking all the action which the public interest requires. Yet the freedom which the central bank requires to fulfill its duties to the nation is not the freedom to evade the public will. If there is a conflict, the political authorities must have their way, preferably by a process which ensures full and informed debate of their actions. While the central bank must be very much an institution of public policy, it must be no less an institution oriented to financial markets. It must be a confidential advisor to the government yet provide the public with the fullest information about its activities. Above all it must be directed by men of integrity and ability—the best designed arrangements in the world will be useless if its management is weak or arrogant or if its political masters are fearful and short-sighted. More and more may come to be known about the techniques and effects of financial policies, but the success of such policies will still depend essentially on the will and wisdom of those who design and execute them.

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CHAPTER 27

FINAL ASSESSMENT AND SUMMARY

Canada's financial institutions and markets have evolved at a quickening pace in the last generation and have on the whole adapted well to the changing needs of borrowers and lenders. They have become more competitive and more alert to opportunities for useful and profitable new business, and there has been a desirable increase in the overlapping of activity among institutions. In the process, however, some gaps have appeared in the framework of regulation designed to protect the public. In addition, certain provisions of laws drawn up for an earlier and different age no longer serve their original purpose: some of them in fact now serve only to raise the costs and inhibit the provision of necessary financial services. Thus we have in general found a good financial system, but some important modifications in its laws and practices are necessary to ensure that it may adapt itself to the evolving economy along safe and constructive paths.

In examining the needs of final lenders and borrowers which the financial system is designed to serve, we noted that the personal sector appears on the whole to manage its finances soundly. As Chapter 2 indicates, the rate of personal saving is high by most standards and the pattern of personal borrowing and investment is generally rational. Debt has risen eleven-fold from its unusually low levels at the end of the war but is still of manageable proportions. Much of it has been incurred for investment in housing and related durables which yield high returns, and much of it replaces previous unrecorded but nevertheless real commitments for rent, laundry and other services. We pointed out that much personal saving is now taking place through pension funds; that government plans have important implications both for the rate of saving and the form it takes; and that their repercussions on the capital market generally, and equity investment in particular, should be most carefully considered. Business investment, which reached abnormally high levels in 1957, has since receded in relative importance; as Chapter 3 shows, this investment is now being largely financed from funds generated internally, with debt ratios remaining quite moderate and beginning to decline after having increased through much of the post-war period. Government financial requirements have risen sharply in recent years, but debt ratios remain favourable by most standards.

Foreign resources have at times in the post-war period supplied a relatively large share of our requirements. However, the fall in the rate of domestic capital formation from its abnormally high levels in the middle and late 1950's and more appropriate financial policies have reduced our drawings on funds generated outside the economy to much more moderate proportions. The relative burden of foreign interest and dividend payments is not large—indeed it is lower than in earlier comparable periods in our history—but the big inflows of direct investment capital which have characterized the post-war wave of foreign investment have led to an increased non-resident control of certain sectors of the economy. While the non-financial issues

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this raises are not ours to analyse, we have pointed out that the ability of Canadians to devote increased amounts to equity investment depends primarily upon increasing their incomes and their ability to save: tax incentives, better disclosure standards and increased institutional equity purchases can also be important in altering the form of savings, but these by themselves will not lead to any significant net increase in the generation of savings by Canadians. If, however, adequate measures are taken to keep the economy competitive, we see no reason why we should expect to be net users of foreign savings when there is slack in the Canadian economy; indeed, the usual delayed adjustment to a more balanced position is already well under way. Nevertheless, foreign capital will continue to make an important contribution to our economic growth, particularly in times of strain on Canadian resources.

While the basic determinants of Canada's economic performance will continue to be the vigour, imagination and self-discipline of the people themselves—as well as the performance of the world economy of which we are a part—wise financial policies can lead to worthwhile improvements in the economy's performance. There are limits to what even the most appropriate policies can accomplish and perfection is not therefore to be expected. Yet the undoubted difficulties of devising and executing good policies are not so serious that we must accept as inevitable the proposition that policy measures will on balance be harmful rather than helpful or be satisfied with mediocre performance. On the contrary, we believe that policy can and should make a positive contribution to the attainment of such goals as low unemployment, price stability, rising efficiency and a sound international position.

We have emphasized that there is no easy or automatic prescription for achieving these or the other goals sought by the community. This is a matter calling for judgment, skill and courage on the part of the authorities. The particular combination of objectives which the public is willing to support is not unchanging and neither are the problems to be faced; the best means of dealing with one situation may therefore be quite inappropriate for another even though they appear similar on the surface. We are convinced nevertheless that it will be a rare occasion when a coherent solution and a proper policy set can be achieved by using one of the policy instruments in isolation: effective performance will almost always require a co-ordinated approach and a combination of monetary, fiscal and non-financial measures.

To restate in detail all our recommendations in the full context in which they were made would be to repeat unnecessarily the argument of earlier chapters. On the other hand, to attempt to summarize them apart from this context and without the qualifications attaching to them would be at best of little value and at worst misleading. In the pages which follow, therefore, we have merely sketched in the main lines of our reasoning and the broad groups of recommendations to which it gave rise.

PUBLIC PROTECTION

We have argued that the public dealing with the financial institutions and markets can never be guaranteed against loss, but that the best safeguard against this possibility is legislation which provides for adequate disclosure and sets high standards of self-regulation backed up by strong government supervision and powers to enforce proper practices.

The wider coverage of the Bank Act which we have recommended should be an important factor in increasing the protection of the public against avoidable losses. We have suggested that the main features of the present Act be carried forward, and in line with our view that specified asset ratios add little to the soundness of institutions we have not recommended that such ratios be incorporated in the legislation. We pointed out that it is difficult to prescribe specified liquid asset, capital or other ratios that are appropriate for all institutions without at the same time impairing the working of the financial system. We have therefore recommended that the Inspector General of Banks should work out appropriate guide-lines with the institutions concerned and

should be given greater powers to enforce sound practices.

Similarly, in Chapter 9 we recommended strengthening the supervision of local credit unions by the provincial authorities and proposed that the locals be required to belong both to central unions subject to the federal banking regulation and to co-operative mutual aid funds which could assist them in times of difficulty. In Chapter 13 we recommended that pension funds—a growing source of savings—be subject to certain broad rules governing their solvency, eliminating the possibility of conflict of interest, and requiring some diversification of investment.

In Chapters 16 and 17, we recommended that the securities markets and dealers be more closely integrated into the framework of government regulation. Despite the significant improvements which have taken place in the industry's standards of self-regulation—which govern both professional ethics and financial requirements—we believe that government securities regulation should be further strengthened and a federal regulatory agency established to give leadership in this field and to work in co-operation with the provincial authorities. We also believe that corporate disclosure standards in Canada are inadequate and that more stringent requirements should be enacted into law as part of a program designed to encourage the development of a better-informed Canadian investor community willing to purchase Canadian equities. It is our view that the public interest would be better served, and the investor better protected, if securities dealers were to disclose more information about their own financial position. A number of other specific recommendations are designed to serve the same ends, including the recommendation that stock exchanges prohibit use of their facilities for primary distribution of speculative securities, that they adopt more stringent listing and delisting standards, that they increase their permanent staff and give it more power and that they recruit a number of outside governors to represent the public interest.

PROMOTING FREE FLOWS OF FUNDS

We have emphasized throughout our report the advantages of allowing the financial institutions to compete as freely as possible for business, subject to the regulation necessary for the protection of their customers. Many of the present investment restrictions contribute nothing to public protection, impose inequitable constraints on the institutions and thus serve only to reduce the efficiency with which a more competitive system could serve the country. These blockages in the financial system frequently cause the public to pay higher prices for credit, and sometimes prevent it from getting credit at all. Thus the present 66⅔% loan to value ratio on first mortgages has reduced the amount of first mortgage lending and forced many borrowers to use the higher-cost second mortgage market. Newer and more reputable unregulated lenders have now entered the field—which the caisses populaires have for many years served soundly and economically in Quebec—and the regulated institutions are working under increasing competitive disadvantages. We have seen some merit in retaining a guide-line to sound lending practice in the first mortgage field but have recommended that the maximum loan to value ratio be raised to 75%. Together with our recommendation that the present chartered banks be allowed to enter the conventional mortgage field—in which they can safely invest a portion of their funds—this should significantly improve the facilities for financing existing properties in Canada and make unnecessary any extension of government guarantee facilities. Our recommendation that the N.H.A. rate on new housing be set free should also improve the flow of private mortgage funds into new housing and make this market less subject to sharp variations arising from the rigidity of the rate and from changes in government direct lending. The desirable transition to increased private N.H.A. lending and reduced direct lending by CMHC might be assisted if the government were to compete less with the institutional collectors of savings through its Canada Savings Bond program.

We have also recommended that the valuation and equity rules governing life insurance company investment be relaxed to encourage the institutions to invest in common shares: a 25% maximum for equities should give them enough scope for the present but the matter can be reviewed again in a few years if higher ratios seem appropriate. Finally, we have recommended the removal of the present 6% maximum lending rate applying to the chartered banks: like the mortgage prohibitions, this impedes the flow of credit to some borrowers and—by driving them to higher-cost lenders—frequently harms the very people it is designed to help. Moreover, the chartered banks are unable at times to pay as high returns on their liabilities as they otherwise might. Some savers are accordingly penalized, although others are able to obtain higher returns on their funds from the unrestricted institutions which are direct competitors of the banks.

Government institutions and guarantees can play a part in encouraging private lenders to be more venturesome and in developing new techniques and facilities—the auctioning of mortgages by CMHC is a recent example—but care must be taken to ensure that government programs do not inhibit private lending by making credit available at rates below the market. We have accordingly recommended in Chapter 12 that some government guarantee programs be discontinued, that those which are retained be made more flexible and that government lending agencies should keep their rates in line with market rates. For example, rates on Farm Credit Corporation loans are now below those the government itself pays for comparable funds, having been left unchanged at 5% since the days when government rates were under 3%. Nevertheless, the Corporation has a useful role to play and we have accordingly recommended that the maximum size of its loans be increased at the same time as its lending rates are brought more into line with levels prevailing elsewhere in the market. Similarly, we have recommended that the Industrial Development Bank give less emphasis to competing with private lenders and put more stress on encouraging the provision of new private facilities and on supplying financial advice and guidance to small business borrowers. We have, however, seen no need to establish new regional or other government lending agencies and programs since we have not found evidence of significant "gaps" in the financial system.

Greater competition will be a valuable spur to improve service and pioneer new developments. If unregulated, however, it can also lead to unsound investment practices and to the possibility of exploitation of the public. The first danger can be guarded against by the regulatory authorities in the ordinary course of their work, but the second requires additional legislative provisions. Accordingly, we have recommended in Chapter 19 that all personal cash lending, not just that covered by the Small Loans Act, be subject to a maximum charge on all amounts up to $5,000 rather than the present $1,500. This extension should help to curb the exploitation of ill-informed borrowers by certain fringe institutions and lenders. We also recommend that the formula retain the present 2% per month maximum on the first $300 borrowed—on which administrative expenses are high—and that a flat rate of 1% per month apply to all higher amounts (the present ½ of 1% applying to amounts between $1,000 and $1,500 merely checks lending in this range).

We would not wish to suggest that legislative changes alone will make for a competitive and adaptable financial system. This will depend also on the attitudes and initiative of the institutions and market participants themselves. They alone can ensure that they do not become excessively bound by tradition or by the conventional rules of thumb necessary for the day-to-day conduct of their business. A competitive framework will, however, make it more difficult for them to escape the consequences of such actions and should ensure that less energy is devoted to excessive branch openings and to competition in terms of size and that more emphasis is given to competing in terms of prices and other financial services.

A COMPETITIVE BANKING SYSTEM

Against the background of this desire to promote the further development of a freely competitive system under sound and equitable regulation, we have devoted considerable attention to the banking institutions and have emphasized the very close similarities between those institutions which we happen in this country to call banks and those called by other names. In principle they carry out many of the same functions and in practice there is no longer any basis for governing them by different sets of regulations. Banks cannot "create" credit in some mysteriously different way from the others, as we pointed out in Chapter 6, and all institutions play an essentially similar role in the flow of credit from lenders to borrowers. What differentiates the banking institutions is the nature of the liabilities they offer—short-term and demand claims which serve as a means of payment or as close substitutes for it. We have concluded that the present assortment of laws governing such institutions is no longer suited to the needs of the country: it subjects them to illogical and inequitable restrictions which do not serve them, the financial system or the community well while failing in some cases to provide adequate supervision of their activities.

We have accordingly recommended in Chapters 18 and 19 that the Bank Act be extended to cover a wider group of institutions which are now engaged in the business of banking, that those not coming under the legislation be prohibited from undertaking this business and that a broader range of lending powers be granted to all banking institutions. Thus in addition to leading to removal of the 6% ceiling and mortgage prohibition applying to the present chartered banks, our recommendations would permit the savings banks and the trust, loan and other companies coming under the banking legislation to compete for commercial and personal lending business. We have, however, recommended that all banking institutions be required to maintain uniform cash reserve ratios against their short-term liabilities, the ratio being lower against genuine notice claims than against demand obligations. While this may have some desirable effect in encouraging the institutions to manage their other assets so as to maintain adequate liquidity, our main purpose has been to ensure that all institutions doing similar business are equitably treated within the system of monetary control.

There is a danger that competition can be weakened by collusion or excessive concentration of power. This is particularly the case with the banking institutions and we have therefore recommended in Chapter 18 that there be a prohibition on agreements between them with respect to lending and borrowing rates, and that this prohibition be supported by appropriate powers and penalties. We have also recommended that no banking institution may own more than a 10% interest in the equity or voting shares of any non-financial firm and noted our disapproval of the practice of bank officers or employees serving as directors of commercial concerns. To prevent undue concentration in the banking and financial system we have recommended that no banking institution be allowed to acquire more than a 10% interest in the equity or voting shares of any non-bank financial institution. We have also made recommendations whose effect will be to maintain the present prohibition on one chartered bank investing in the stock of another and to prevent all other equity investments among banking institutions unless permission is first obtained from the Treasury Board (subject to an exception when two small institutions are involved). In addition we have recommended that the Board be empowered to review any such acquisition in subsequent years and that it have power to order such remedy as is necessary to preserve competition in the public interest. We have also suggested that there be statutory limits on interlocking directorates between banking institutions. Finally, we recommend that the anomaly in the present law, which prohibits share ownership of one Canadian bank by another but is silent on foreign bank ownership, be removed (although express provision

should be made for the establishment of foreign bank agencies under the Bank Act). Such provisions, while not ruling out bank mergers or acquisitions which may enhance competition or protect the public interest, will subject all sizable transactions to prior scrutiny by the authorities and enable them to ensure that an excessive concentration of power does not develop.

We have, in summary, favoured a more open and competitive banking system—carefully and equitably regulated under uniform legislation but not bound by restrictions which impede the response of the institutions to new situations, enforce a particular pattern of narrow specialization or shelter some enterprises from competitive pressures. We believe that this framework will encourage creativity and efficiency and offer the public the widest possible range of choice of financial services, while reducing the danger of unregulated institutions springing up to serve real needs which others are prevented from meeting. Some institutions may attempt to offer a full range of services and others may choose to specialize in a variety of ways, but the legislation will allow all of them—and such new institutions as are qualified—to adapt to new opportunities and situations created by changing public preferences and needs.

ECONOMIC AND FINANCIAL POLICY

We concluded from our examination of economic policy that monetary measures used within their postwar range of variation are unlikely to have sufficiently powerful effects to combat strong cyclical fluctuations by themselves. In very short cycles, moreover, the inevitable lags in the effects of monetary measures reduce their usefulness still further, although the delayed effects of a policy of restraint are unlikely to be sufficiently serious in the ensuing recession to inhibit their use if reasonably prompt shifts in policy are made. In conditions of prolonged boom, there is of course some point at which high interest rates would by themselves effectively restrict economic activity, but we indicated that there are practical limits to how far rates can be raised. In conditions of serious weakness, on the other hand, it is not possible by conventional monetary measures to provide a major stimulus to the economy, especially if profit prospects are unfavourable and excess capacity is widespread. Over a long period, however, persistent monetary ease may be more helpful, although we have no real evidence on the point.

In Chapter 22, we noted that debt management can sometimes play a useful supporting role in altering credit conditions and should in any event be co-ordinated with monetary policy. However, the evidence does not suggest that it is a powerful and separate instrument for influencing credit conditions. We also pointed out that it is not technical limitations which prevent the authorities from varying credit conditions more. Operating techniques are of secondary importance compared to the set of policy itself, and while it is important to ensure that they do not disrupt markets and public confidence needlessly, the authorities have no reason to bind themselves to a particular group of operating rules in the securities or other markets.

Our findings also suggest that there may be emergency conditions when international limitations or urgent domestic circumstances justify the use of direct credit measures designed to limit the availability of funds to borrowers with a dampened effect on interest rates or to obtain more pronounced effects than can be expected from general credit policy. However, the frequent use of direct measures will disrupt and weaken financial markets and may induce the authorities to be less careful in the use of more general measures in the knowledge that they can subsequently impose controls. Moreover, the capital markets will develop ways—admittedly inefficient but nevertheless effective—of circumventing the direct measures. Such measures should therefore be sparingly used and removed as soon as possible after the emergency has ended.

The limitations of monetary measures lead us to conclude that they must normally be supplemented by fiscal measures designed to operate more directly on the flow of incomes and expenditures. Discretionary fiscal policy can, we

believe, be used over a wider range than has been the case in the post-war period—provided that measures are carefully planned and that irreversible expenditure commitments are not made. The need for massive tax or expenditure changes should be rare, but there may be infrequent occasions when substantial changes in taxes on investment goods or in capital cost allowances can play a useful role in affecting the timing of investment. We have pointed out that to be fully effective, fiscal measures of a major kind necessarily involve close co-ordination and co-operative consultation with the provincial governments since these governments now account for an important and rising share of government expenditures on goods and services.

We have emphasized also that non-financial policies can make an important contribution to our major national objectives, particularly that of increasing efficiency. Both fiscal and non-financial measures take on increased importance as instruments for achieving our domestic objectives under a fixed exchange rate system, since under this system monetary measures must be geared more closely to external considerations. We have laid stress throughout the report on the increasingly close links between the capital markets of Canada and other countries, and emphasized that international financial flows are highly sensitive to changes in interest rate differentials, which can be readily influenced by the monetary authorities. While Canada is bound to be influenced by external developments under any exchange rate system, our links with the rest of the world have more immediate consequences for monetary policy under a fixed exchange rate.

We have ruled out attempts to isolate ourselves from the international economic community by direct measures because of the high price such efforts would involve in terms of reduced efficiency and growth. Indeed, it is only by keeping the economy adaptable and competitive that we can build a viable international position which minimizes the possibility of conflicts between external considerations and domestic objectives. As a country linked more closely than most to the world economic community, Canada has a particular interest in ensuring that international financial and payments arrangements are adequate to encourage world growth without inflation. We have therefore urged in Chapter 23 that the country should play a constructive role in the discussions now under way to make modifications in this system by providing access to additional currency reserves for countries which need time to carry out the fundamental adjustments required to improve their competitive positions.

Throughout the latter part of the report, we have emphasized the many inter-relations between monetary, fiscal, exchange rate and other policies and drawn attention to the important impact which a concerted program of such policies can have on the economy. The effects of individual strands of policy may not be as large as some have thought, but in total their effect is impressive: indeed, this total is undoubtedly more than the sum of its component parts. Hence our stress on the importance of the proper co-ordination of policy, our recommendations for strengthening the policy-making staff of the federal government, and our urging that more careful consideration be given to the immediate and long-run costs and benefits of following one policy rather than another. However, since many of the policy failures in the post-war period have come about from a reluctance to take the necessary action, partly out of fear of lack of public support, we have also put considerable emphasis on the importance of far-sighted political leadership and the development of a more informed public opinion.

The principal task facing the authorities is to get the broad set and timing of policies right—to influence aggregate demand in the right direction. These policies may need to be supplemented by more specific measures to influence the allocation of resources within the total, but such measures will be largely ineffective as instruments of attaining our major objectives if the whole policy climate is wrong. The particular mix of policies needed will vary with the circumstances —sometimes one instrument may even have to be

used in a different direction from the others as part of a conscious program to achieve particular aims. There will not normally be a wide choice of policy combinations open to the authorities to achieve our other major goals at full employment levels. In any event, there is no presumption that any one combination of policies is in all circumstances particularly favourable to productivity gains and price stability. Apparently similar circumstances may in fact call for differing policy approaches and the authorities cannot be guided by doctrinaire preferences for emphasizing one policy instrument rather than another.

In the previous chapter, we emphasized that the Bank of Canada must be regarded as a policy arm of the government. There are, however, special reasons why in its role as manager of the currency and as a market and financial advisor to the Minister of Finance it should have some independence of status within government. At the same time, a mechanism must exist for the government to be able to exercise its responsibility for monetary policy in the event of a conflict. We have accordingly recommended the establishment of a directive procedure—which we hope will never need to be used—to accomplish this aim, while at the same time ensuring a maximum of public debate and discussion of the issues raised. As with all relationships, however, that between the Governor of the Bank and the Minister of Finance depends ultimately on the responsibility and good sense of those involved. Having stressed the important role which the directors and senior staff of the Bank can also play in that institution's affairs, we have made a number of specific suggestions designed to ensure that the quality and background of these key people are of the high standard required. Because of the importance for effective monetary policy of close links and understanding between the Bank on the one hand and the financial community and broader public on the other hand, we have also made a number of recommendations designed to improve the contacts between the Bank and the markets and public.

In summary, the changes we have recommended in the area of policy and policy-making are related to the approaches which should be taken by those concerned rather than with the establishment of new rules or laws. Taken together with the more adaptable and competitive framework of regulation which we have proposed for the financial institutions and markets, and with the modifications to lending practices which we have suggested, we believe a wise approach to financial policy should significantly improve the economy's ability to perform well and adjust to the changing needs of its citizens. We must emphasize again, however, that there is no arrangement of the financial system which can guarantee the attainment of national economic objectives: financial institutions, markets and policies can only influence the climate and create the facilities necessary to reach these goals. If they are constructive and innovating in their approach, they will help to achieve them, while if they are not, attempts to do so will be frustrated. The approach which we have taken is designed to favour such creative evolution of the financial system. We are convinced that the changes which have been occurring since the time of our predecessors on the Macmillan Commission will continue at an accelerated pace and that it would be impossible —even dangerous—to attempt to prescribe for every possible future contingency. While we cannot foresee the precise pattern of financial developments in the next generation, we are confident that our successors will find a financial system which played its full part in responding to the continuing challenge of building a great nation.

ALL OF WHICH WE RESPECTFULLY SUBMIT FOR YOUR EXCELLENCY'S CONSIDERATION.

Dana Harris Porter

Chairman

W. Thomas Brown

James Douglas Patterson

Gordon L. Harold

Carl H. Leman

John C. MacLeod

H. Coe Aitken

Harold Aultman Hopper

Secretary

Nikki Freeman

Joint Secretary

February 5, 1964.

APPENDIX 1

THE ORDER IN COUNCIL

P.C. 1961-1484

Certified to be a true copy of a Minute of a Meeting of the Committee of the Privy Council, approved by His Excellency the Governor General on the 18th October, 1961

The Committee of the Privy Council have had before them a report from the Minister of Finance, representing:

That it is desirable periodically to undertake a broad review of the functioning of the Canadian financial system;

That the last review of this nature took place in 1933;

That, in the meantime, the Canadian economy, its financial resources and its financial requirements have grown and changed greatly;

That orderly economic growth is dependent in no small measure on the adequacy and adaptation of the financial institutions through which funds are made available for expansion and development; and

That the charters of the banks under the Bank Act and the Quebec Savings Banks Act expire in 1964 and that these Acts should be carefully reviewed before that time.

The Committee therefore advise that:

The Honourable Dana Harris Porter,
Chief Justice of Ontario,
Toronto, Ontario

Mr. W. Thomas Brown, M.B.E.,
Investment dealer,
Vancouver, British Columbia

Mr. James Douglas Gibson, O.B.E.,
Banker,
Toronto, Ontario

Mr. Gordon L. Harrold,
Agriculturist,
Calgary, Alberta

Mr. Paul H. Leman,
Corporation executive,
Montreal, Quebec

Mr. John C. MacKeen,
Corporation executive,
Halifax, Nova Scotia

Dr. W. A. Mackintosh,
Vice-Chancellor, Queen's University,
Kingston, Ontario

be appointed Commissioners under Part I of the Inquiries Act

(*a*) to enquire into and report upon the structure and methods of operation of the Canadian financial system, including the banking and monetary system and the institutions and processes involved in the flow of funds through the capital market; and

(*b*) to make recommendations

(i) for the improvement of the structure and operations of the financial system and, more particularly,

(ii) concerning the Bank Act, the Bank of Canada Act, the Quebec Savings Banks Act, and other relevant federal legislation.

The Committee further advise:

1. That the Commissioners be authorized to exercise all the powers conferred upon them by section 11 of the Inquiries Act and be assisted to the fullest extent by government departments and agencies;

2. That the Commissioners adopt such procedures and methods as they may from time to time deem expedient for the proper conduct of the inquiry and sit at such times and at such places in Canada as they may decide from time to time;

3. That the Commissioners be authorized to engage the services of such counsel, staff and technical advisers as they may require at rates of remuneration and reimbursement to be approved by the Treasury Board;

4. That the Commissioners report to the Governor in Council with all reasonable despatch, and file with the Dominion Archivist the papers and records of the Commission as soon as reasonably may be after the conclusion of the inquiry;

5. That the Honourable Mr. Chief Justice Porter be Chairman of the Commission; and

6. That Mr. Harold Anthony Hampson of the City of Toronto be Secretary of the Commission.

R. B. Bryce,
Clerk of the Privy Council.

APPENDIX 2

SCHEDULE OF COMMISSION HEARINGS

The Commission held 69 days of public hearings at the eleven centres listed below at which 95 briefs were presented and discussed:

Victoria, B.C.	March 12, 1962
Vancouver, B.C.	March 13-16
Edmonton, Alta.	March 19 & 20
Regina, Sask.	March 22 & 23
Winnipeg, Man.	April 9 & 10
Toronto, Ont.	April 12-17
Montreal, Que.	May 14-17
Fredericton, N.B.	June 4 & 5
Charlottetown, P.E.I.	June 7
Halifax, N.S.	June 11-12
Ottawa, Ont.	July 9-20
Ottawa, Ont.	Sept. 10-28
Ottawa, Ont.	Oct. 16-Nov. 1
Ottawa, Ont.	Jan. 7-22, 1963

APPENDIX 3

ACKNOWLEDGEMENTS

We have had many occasions in the 2½ years since our appointment to appreciate the generous help which we have received from all quarters. No body such as ours could begin to discharge its task without relying heavily on the willing co-operation of many organizations and individuals. We received this support in full measure—not only from all parts of the financial community, but also from governments, non-financial businesses and others who contributed facts, opinions and suggestions which helped us to reach a better understanding of the workings of the Canadian financial system.

Valuable information and ideas were contained in the many briefs submitted to us by organizations and individuals across Canada and discussed extensively at our public hearings. The complete list of submissions will be found below. We wish to extend special thanks to the distinguished group of foreign central bankers and economists who helped to make our education in financial matters such a stimulating and enjoyable experience. The late Sir Dennis Robertson's wit and clarity on central banking policy have been beyond our powers to emulate, but we hope the discussions he had with us have left some mark in our report. Lord Cobbold, Dr. Holtrop, Mr. Thomas and Mr. Sproul each gave us forceful and perceptive insights into the duties and problems of central bankers and provided us with many interesting ideas on the theory and practice of their profession. Mr. Lundberg's full discussion of the implications of some of Sweden's credit and other economic policies and the wide-ranging exchanges we had with Professors Viner and Samuelson and with Mr. Bernstein all contributed to improving our understanding of both the international and domestic consequences of financial measures.

We have necessarily relied extensively on both the private financial institutions and government bodies, and we are indebted to them for the prompt and co-operative way in which they met the many requests from us and our staff for statistical and other information about their operations. Among those deserving special mention are the representatives and officers of the credit unions and caisses populaires across the country, of the Canadian Bankers' Association and its individual members, and of the two Quebec Savings Banks. No less valuable were the contributions of the Trust Companies Association of Canada and their members—in particular the Royal, Montreal, and National Trust Companies which undertook an extensive survey of their estate, trust and agency accounts for us. The principal stock exchanges, the Investment Dealers' Association of Canada and many provincial securities commissions assisted us immeasurably, while The Federated Council of Sales Finance Companies provided us with much additional information on their industry. Our thanks are also due to the Canadian Life Insurance Officers Association—and in particular to 12 of its members who compiled new statistical information—as well as to the Dominion Mortgage & Investments Association, the Canadian Consumer Loan Association and the recently-formed Canadian Mutual Funds Association.

Public bodies, too, made valuable contributions to our work. The Industrial Development Bank, Export Credits Insurance Corporation and Central Mortgage and Housing Corporation each assisted us with facts and opinions about the

special financial markets in which they work, while the Dominion Bureau of Statistics lent its usual valuable assistance to many phases of our enquiry. Officers of the Department of Finance were always willing to answer our queries and the Inspector General of Banks was especially helpful to us because of his thorough knowledge of the Canadian banking system. The Bank of Canada eased our task throughout—in its excellent submission, in the administrative and research assistance it gave to us and our staff, and in the personnel it made available for our work.

Organizations representing labour, agriculture and business all prepared able and thoughtful submissions for us. In addition, members of our staff conducted mail and direct-interview surveys with over 1,500 firms and provincial and municipal governments, all of whom cooperated fully in our enquiry and many of whom went to additional time and trouble to assist us and to let us have their considered comments on the operation of the financial system. Finally, some 1,200 households obligingly submitted themselves to a lengthy questionnaire about their financial affairs: to them and to McDonald Research Limited, who conducted the survey for us, we express our sincere thanks.

We were fortunate not only in the outside assistance we received, but in the high quality of our research staff. We extend our thanks to them for their excellent work and express our indebtedness for the contribution which they made to the development of our thinking. A list of the staff is given elsewhere: in addition, valuable papers were prepared for us by A. W. Johnson of the Government of Saskatchewan, E. K. Cork of Noranda Mines Limited, G. D. Sutton of Nesbitt, Thomson and Company Limited, D. H. C. Stanley of Wood, Gundy & Company Limited, J. D. McNeil of the Sun Life Assurance Company of Canada and by M. A. Crowe of the Canadian Imperial Bank of Commerce. To them and to their employers we express our gratitude. We would also like to record our appreciation to Messrs. J. M. Andrews and W. A. McKay of the Bank of Canada who assisted in parts of our research and to Dr. D. W. Carr and his associates for their study of agricultural finance in Canada.

Professor William C. Hood, in addition to his role as Director of Research, served as our Economic Advisor and in both capacities helped us to an understanding of the complexities of the financial system and the framework of economic policy. We were fortunate to have the guidance of such an outstanding scholar. He was ably supported by our three Assistant Research Directors: Dr. D. J. Daly was responsible for studies of the financial needs of the main sectors of the economy and provided us with fresh and interesting ideas on the long-run implications of financial policy; Mr. R. Johnstone directed the studies of the financial institutions and markets, contributed much to our perspective on the behaviour of the financial system and assisted in the drafting of large parts of the report; Dr. J. H. Young was responsible for the studies of financial policies and played the major role in our survey of corporate and government response to changing credit conditions—in these studies and in the drafting of part of the report he helped us to develop our views on the strengths and weaknesses of the different policy instruments.

The Commission's affairs were managed throughout with unobtrusive efficiency, thanks in no small part to the work of our Administrative Secretary, Mr. Leo Lafrance, who cheerfully relieved us of all worry about the myriad administrative problems inherent in any government body. Mr. Gilles Mercure, the Joint Secretary, carried out major research assignments with outstanding success, contributed much sound judgment to the report itself, and handled important administrative duties with skill and good humour. He also assumed overall responsibility for translation of the report and bore much of the burden himself. Our greatest debt has been to Mr. H. A. Hampson, the Secretary of the Commission. His intellect, organizing ability and energy proved invaluable in the planning of our work, the development of our views and the drafting of our entire report.

APPENDIX 4

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Canadian Federation of Mayors and Municipalities
Canadian Importers and Traders Association, Inc.
The Canadian Labour Congress
The Canadian Life Insurance Officers Association
The Canadian Manufacturers' Association
Canadian Metal Mining Association
Canadian Retail Federation
Canadian Small & Independent Business Federation
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* Not presented at the public hearings.

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APPENDIX 6

PUBLICATIONS AND DOCUMENTS

The Commission will be publishing at a later date an appendix volume containing supplementary statistical information and research work, including tabulations and commentary based on the main surveys undertaken for us.

Much of the work contained in the many useful working papers prepared for the internal use of the Commission is incorporated in the report itself. However, the Commission felt that a number of these papers should be available to a wider audience. Accordingly, those listed below are shortly to be put on sale in mimeographed form by the Queen's Printer:

A. Asimakopulos	"The Reliability of Selected Price Indexes as Measures of Price Trends"
D. W. Carr & Associates	"Farm Credit in Canada"
E. K. Cork	"Finance in the Mining Industry"
A. W. Johnson	"Provincial and Municipal Governments and the Capital Markets"
Harry G. Johnson and J. W. L. Winder	"Lags in the Effects of Monetary Policy in Canada"
Gilles Mercure	"Credit Unions and Caisses Populaires"
J. V. Poapst	"The Residential Mortgage Market"
G. L. Reuber	"The Objectives of Monetary Policy"
R. A. Shearer	"Monetary Policy and the Current Account of the Balance of International Payments"
G. D. Sutton	"Corporate Finance"
Sidney Turk	"The Foreign Exchange Market in Canada"
Paul Wonnacott	"The Height, Structure and Significance of Interest Rates"

In addition to these papers, the Commission had certain confidential studies prepared, notably that on debt management by Professor Jacques Parizeau. Moreover, other papers, including that on financing small business by F. X. Wildgen and that on fiscal policy by R. M. Will are to be published in modified form elsewhere. Finally, the paper by Harry G. Johnson on "Alternative Guiding Principles for the Use of Monetary Policy" was published in his book *The Canadian Quandary* (McGraw-Hill, 1963) and that by D. H. C. Stanley on "The Financing of Oil and Gas Exploration and Production in Canada" was privately distributed by Wood, Gundy & Co. Ltd. in 1963.

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